

SANDY SPRING BANCORP INC  
Form 10-Q  
August 09, 2012

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

**For the Quarterly Period Ended June 30, 2012**

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to \_\_\_\_\_

Commission File Number: 0-19065

SANDY SPRING BANCORP, INC.

(Exact name of registrant as specified in its charter)

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Maryland 52-1532952  
(State of incorporation) (I.R.S. Employer Identification Number)

17801 Georgia Avenue, Olney, Maryland 20832  
(Address of principal executive office) (Zip Code)

**301-774-6400**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)

Yes  No

The number of outstanding shares of common stock outstanding as of August 7, 2012.

**Common stock, \$1.00 par value – 24,890,484 shares**



**SANDY SPRING BANCORP, INC.**

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## Forward-Looking Statements

This Quarterly Report on Form 10-Q, as well as other periodic reports filed with the Securities and Exchange Commission, and written or oral communications made from time to time by or on behalf of Sandy Spring Bancorp and its subsidiaries (the “Company”), may contain statements relating to future events or future results of the Company that are considered “forward-looking statements” under the Private Securities Litigation Reform Act of 1995. These forward-looking statements may be identified by the use of words such as “believe,” “expect,” “anticipate,” “plan,” “estimate,” “intend” and “potential,” or words of similar meaning, or future or conditional verbs such as “should,” “could,” or “may.” Forward-looking statements include statements of our goals, intentions and expectations; statements regarding our business plans, prospects, growth and operating strategies; statements regarding the quality of our loan and investment portfolios; and estimates of our risks and future costs and benefits.

Forward-looking statements reflect our expectation or prediction of future conditions, events or results based on information currently available. These forward-looking statements are subject to significant risks and uncertainties that may cause actual results to differ materially from those in such statements. These risk and uncertainties include, but are not limited to, the risks identified in Item 1A of this report and the following:

- general business and economic conditions nationally or in the markets that the Company serves could adversely affect, among other things, real estate prices, unemployment levels, and consumer and business confidence, which could lead to decreases in the demand for loans, deposits and other financial services that we provide and increases in loan delinquencies and defaults;

- changes or volatility in the capital markets and interest rates may adversely impact the value of securities, loans, deposits and other financial instruments and the interest rate sensitivity of our balance sheet as well as our liquidity;

- our liquidity requirements could be adversely affected by changes in our assets and liabilities;

- our investment securities portfolio is subject to credit risk, market risk, and liquidity risk as well as changes in the estimates we use to value certain of the securities in our portfolio;

- the effect of legislative or regulatory developments including changes in laws concerning taxes, banking, securities, insurance and other aspects of the financial services industry;

- competitive factors among financial services companies, including product and pricing pressures and our ability to attract, develop and retain qualified banking professionals;

the effect of changes in accounting policies and practices, as may be adopted by the Financial Accounting Standards Board, the Securities and Exchange Commission, the Public Company Accounting Oversight Board and other regulatory agencies; and

the effect of fiscal and governmental policies of the United States federal government.

Forward-looking statements speak only as of the date of this report. We do not undertake to update forward-looking statements to reflect circumstances or events that occur after the date of this report or to reflect the occurrence of unanticipated events except as required by federal securities laws.

**Part I****Item 1. FINANCIAL STATEMENTS****Sandy spring bancorp, inc. and subsidiaries****CONDENSED Consolidated STATEMENTS OF CONDITION – UNAUDITED**

| (Dollars in thousands)  | June 30,<br>2012 | December 31,<br>2011 |
|---|------------------|----------------------|
| <b>Assets</b>   |                  |                      |
| Cash and due from banks   | \$46,002         | \$ 49,832            |
| Federal funds sold  | 467              | 1,006                |
| Interest-bearing deposits with banks  | 76,365           | 21,476               |
| Cash and cash equivalents   | 122,834          | 72,314               |
| Residential mortgage loans held for sale (at fair value)  | 25,827           | 25,341               |
| Investments available-for-sale (at fair value)  | 808,881          | 951,301              |
| Investments held-to-maturity — fair value of \$169,396 and \$184,167 at June 30, 2012 and December 31, 2011, respectively   | 164,846          | 178,465              |
| Other equity securities   | 33,016           | 34,933               |
| Total loans and leases  | 2,475,078        | 2,239,692            |
| Less: allowance for loan and lease losses   | (45,265 )        | (49,426 )            |
| Net loans and leases  | 2,429,813        | 2,190,266            |
| Premises and equipment, net   | 49,240           | 48,483               |
| Other real estate owned   | 9,553            | 4,431                |
| Accrued interest receivable   | 13,456           | 12,898               |
| Goodwill  | 81,892           | 76,816               |
| Other intangible assets, net  | 4,017            | 4,734                |
| Other assets  | 111,802          | 111,388              |
| Total assets  | \$3,855,177      | \$ 3,711,370         |
| <b>Liabilities</b>  |                  |                      |
| Noninterest-bearing deposits  | \$763,566        | \$ 650,377           |
| Interest-bearing deposits   | 2,088,489        | 2,006,143            |
| Total deposits  | 2,852,055        | 2,656,520            |
| Securities sold under retail repurchase agreements and federal funds purchased  | 64,779           | 143,613              |
| Advances from FHLB  | 405,233          | 405,408              |
| Subordinated debentures   | 35,000           | 35,000               |
| Accrued interest payable and other liabilities  | 26,646           | 24,720               |
| Total liabilities   | 3,383,713        | 3,265,261            |
| <b>Stockholders' Equity</b>   |                  |                      |
| Common stock — par value \$1.00; shares authorized 50,000,000; shares issued and outstanding 24,886,724 and 24,091,042 at June 30, 2012 and December 31, respectively | 24,887           | 24,091               |
| Additional paid in capital  | 190,733          | 177,828              |
| Retained earnings   | 241,267          | 230,942              |



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|  |             |              |
|--|-------------|--------------|
| Accumulated other comprehensive income     | 14,577      | 13,248       |
| Total stockholders' equity                 | 471,464     | 446,109      |
| Total liabilities and stockholders' equity | \$3,855,177 | \$ 3,711,370 |

The accompanying notes are an integral part of these statements

## Sandy Spring Bancorp, Inc. and Subsidiaries

## CONDENSED Consolidated Statements of IncomeE – UNAUDITED

|   | Three Months |          | Six Months Ended |          |
|---|--------------|----------|------------------|----------|
|   | Ended        |          | Ended            |          |
| (Dollars in thousands, except per share data)                                 | June 30,     | 2011     | June 30,         | 2011     |
| Interest Income:  |              |          |                  |          |
| Interest and fees on loans and leases   | \$28,338     | \$26,816 | \$55,467         | \$53,806 |
| Interest on loans held for sale   | 190          | 124      | 339              | 246      |
| Interest on deposits with banks   | 24           | 21       | 45               | 39       |
| Interest and dividends on investment securities:                              |              |          |                  |          |
| Taxable   | 4,662        | 5,649    | 9,605            | 11,089   |
| Exempt from federal income taxes  | 2,343        | 2,398    | 4,716            | 4,577    |
| Interest on federal funds sold  | 1            | -        | 1                | 1        |
| Total interest income   | 35,558       | 35,008   | 70,173           | 69,758   |
| Interest Expense:   |              |          |                  |          |
| Interest on deposits  | 1,871        | 2,987    | 3,884            | 5,900    |
| Interest on retail repurchase agreements and federal funds purchased          | 51           | 53       | 112              | 106      |
| Interest on advances from FHLB  | 3,586        | 3,590    | 7,173            | 7,141    |
| Interest on subordinated debt   | 241          | 224      | 490              | 447      |
| Total interest expense  | 5,749        | 6,854    | 11,659           | 13,594   |
| Net interest income   | 29,809       | 28,154   | 58,514           | 56,164   |
| Provision for loan and lease losses   | 1,585        | 1,151    | 2,249            | 2,666    |
| Net interest income after provision for loan and lease losses                 | 28,224       | 27,003   | 56,265           | 53,498   |
| Non-interest Income:  |              |          |                  |          |
| Investment securities gains   | 90           | 32       | 163              | 52       |
| Total other-than-temporary impairment ("OTTI") losses                         | (8 )         | (43 )    | (72 )            | (102 )   |
| Portion of OTTI losses recognized in other comprehensive income, before taxes | -            | -        | -                | 18       |
| Net OTTI recognized in earnings   | (8 )         | (43 )    | (72 )            | (84 )    |
| Service charges on deposit accounts   | 2,283        | 2,437    | 4,483            | 4,689    |
| Mortgage banking activities   | 1,288        | 808      | 2,313            | 1,263    |
| Wealth management income  | 4,034        | 4,023    | 8,091            | 7,668    |
| Insurance agency commissions  | 934          | 953      | 2,136            | 2,133    |
| Income from bank owned life insurance   | 660          | 654      | 1,294            | 1,300    |
| Visa check fees   | 962          | 949      | 1,860            | 1,783    |
| Other income  | 1,250        | 989      | 2,199            | 1,990    |
| Total non-interest income   | 11,493       | 10,802   | 22,467           | 20,794   |
| Non-interest Expenses:  |              |          |                  |          |
| Salaries and employee benefits  | 15,927       | 14,676   | 31,628           | 29,300   |
| Occupancy expense of premises   | 2,943        | 2,790    | 5,789            | 5,933    |
| Equipment expenses  | 1,255        | 1,128    | 2,445            | 2,270    |
| Marketing   | 565          | 709      | 1,060            | 1,194    |
| Outside data services   | 1,828        | 999      | 3,107            | 1,994    |

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|                                   |         |         |          |          |
|-----------------------------------|---------|---------|----------|----------|
| FDIC insurance                    | 653     | 736     | 1,305    | 1,780    |
| Amortization of intangible assets | 466     | 462     | 927      | 923      |
| Other expenses                    | 5,221   | 4,338   | 9,280    | 8,506    |
| Total non-interest expenses       | 28,858  | 25,838  | 55,541   | 51,900   |
| Income before income taxes        | 10,859  | 11,967  | 23,191   | 22,392   |
| Income tax expense                | 3,652   | 3,671   | 7,508    | 6,805    |
| Net income                        | \$7,207 | \$8,296 | \$15,683 | \$15,587 |
| Net Income Per Share Amounts:     |         |         |          |          |
| Basic net income per share        | \$0.30  | \$0.34  | \$0.65   | \$0.65   |
| Diluted net income per share      | \$0.30  | \$0.34  | \$0.65   | \$0.65   |
| Dividends declared per share      | \$0.12  | \$0.08  | \$0.22   | \$0.16   |

The accompanying notes are an integral part of these statements

**Sandy Spring Bancorp, Inc. and Subsidiaries****CONDENSED Consolidated Statements of OTHER COMPREHENSIVE INCOME - UNAUDITED**

| (In thousands)  | Three Months Ended June |           | Six Months Ended June |           |
|---|-------------------------|-----------|-----------------------|-----------|
|   | 30,<br>2012             | 2011      | 30,<br>2012           | 2011      |
| Net income  | \$ 7,207                | \$ 8,296  | \$ 15,683             | \$ 15,587 |
| Other comprehensive income:   |                         |           |                       |           |
| Investments available-for-sale:   |                         |           |                       |           |
| Net change in unrealized gains (losses) on investments available-for-sale | 2,452                   | 12,570    | 1,349                 | 12,833    |
| Related income tax expense  | (977 )                  | (5,012 )  | (538 )                | (5,117 )  |
| Net investment gains reclassified into earnings                           | 90                      | 32        | 163                   | 52        |
| Related income tax expense  | (36 )                   | (13 )     | (65 )                 | (21 )     |
| Net effect on other comprehensive income (loss) for the period            | 1,529                   | 7,577     | 909                   | 7,747     |
| Defined benefit pension plan:   |                         |           |                       |           |
| Recognition of unrealized gain  | 349                     | 276       | 699                   | 593       |
| Related income tax expense  | (139 )                  | (109 )    | (279 )                | (236 )    |
| Net effect on other comprehensive income for the period                   | 210                     | 167       | 420                   | 357       |
| Total other comprehensive income (loss)                                   | 1,739                   | 7,744     | 1,329                 | 8,104     |
| Comprehensive income  | \$ 8,946                | \$ 16,040 | \$ 17,012             | \$ 23,691 |

The accompanying notes are an integral part of these statements

**Sandy Spring Bancorp, Inc. and Subsidiaries****CONDENSED Consolidated Statements of Cash Flows – UNAUDITED**

| (Dollars in thousands)   | Six Months Ended June 30, |            |
|--|---------------------------|------------|
|  | 2012                      | 2011       |
| Operating activities:  |                           |            |
| Net income   | \$ 15,683                 | \$ 15,587  |
| Adjustments to reconcile net income to net cash provided by operating activities:        |                           |            |
| Depreciation and amortization  | 3,880                     | 3,684      |
| Net OTTI recognized in earnings  | 72                        | 84         |
| Provision for loan and lease losses  | 2,249                     | 2,666      |
| Share based compensation expense   | 740                       | 590        |
| Deferred income tax expense  | 1,192                     | 2,444      |
| Origination of loans held for sale   | (122,996 )                | (93,302 )  |
| Proceeds from sales of loans held for sale   | 124,489                   | 105,843    |
| Gains on sales of loans held for sale  | (1,979 )                  | (1,474 )   |
| Loss on sales of other real estate owned   | 701                       | 667        |
| Investment securities gains  | (163 )                    | (52 )      |
| (Gains) losses on sales of premises and equipment  | (88 )                     | 18         |
| Net increase in accrued interest receivable  | (558 )                    | (518 )     |
| Net decrease in other assets   | 487                       | 12,483     |
| Net increase in accrued expenses and other liabilities                                   | 2,269                     | 3,830      |
| Other – net  | 3,850                     | 3,914      |
| Net cash provided by operating activities  | 29,828                    | 56,464     |
| Investing activities:  |                           |            |
| Purchases of other equity securities   | (1,382 )                  | -          |
| Purchases of investments held-to-maturity  | (47,916 )                 | (28,974 )  |
| Purchases of investments available-for-sale  | (73,733 )                 | (200,238 ) |
| Proceeds from redemption of Federal Home Loan Bank of Atlanta stock.                     | 3,224                     | 1,007      |
| Proceeds from sales of investment available-for-sale                                     | 28,519                    | -          |
| Proceeds from maturities, calls and principal payments of investments held-to-maturity   | 61,507                    | 30,694     |
| Proceeds from maturities, calls and principal payments of investments available-for-sale | 186,353                   | 122,185    |
| Net (increase) decrease in loans and leases  | (245,594 )                | 5,889      |
| Proceeds from the sales of other real estate owned                                       | 2,402                     | 4,057      |
| Acquisition of business activity, net of cash acquired                                   | (849 )                    | -          |
| Expenditures for premises and equipment  | (2,946 )                  | (2,110 )   |
| Net cash used in investing activities  | (90,415 )                 | (67,490 )  |
| Financing activities:  |                           |            |
| Net increase in deposits   | 195,535                   | 107,989    |
| Net decrease in retail repurchase agreements and federal funds purchased                 | (78,834 )                 | (31,029 )  |
| Repayment of advances from FHLB  | (175 )                    | (175 )     |
| Redemption of stock warrant  | -                         | (4,449 )   |
| Remittances due to the vesting of restricted stock                                       | (136 )                    | 167        |
| Tax benefits associated with shared based compensation                                   | 74                        | -          |
| Dividends paid   | (5,358 )                  | (3,884 )   |
| Net cash provided by financing activities  | 111,106                   | 68,619     |
| Net increase in cash and cash equivalents  | 50,519                    | 57,593     |

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|  |            |            |
|--|------------|------------|
| Cash and cash equivalents at beginning of period | 72,314     | 63,117     |
| Cash and cash equivalents at end of period       | \$ 122,833 | \$ 120,710 |
| Supplemental Disclosures:                        |            |            |
| Interest payments                                | \$ 11,413  | \$ 13,629  |
| Income tax payments                              | 4,086      | 3,600      |
| Transfers from loans to other real estate owned  | 3,798      | 2,868      |

The accompanying notes are an integral part of these statements

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## Sandy Spring Bancorp, Inc. and Subsidiaries

## CONDENSED Consolidated Statements of changes in stockholders' equity - UNAUDITED

| (Dollars in thousands, except per share data)               | Preferred Common |           |          | Additional      | Retained   | Accumulated                       | Total                |
|---|------------------|-----------|----------|-----------------|------------|-----------------------------------|----------------------|
|   | Stock            | Stock     | Warrants | Paid-In Capital | Earnings   | Other Comprehensive Income (Loss) | Stockholders' Equity |
| Balances at January 1, 2012                                 | \$ -             | \$ 24,091 | \$ -     | \$ 177,828      | \$ 230,942 | \$ 13,248                         | \$ 446,109           |
| Net income  | -                | -         | -        | -               | 15,683     | -                                 | 15,683               |
| Other comprehensive income, net of tax                      | -                | -         | -        | -               | -          | 1,329                             | 1,329                |
| Common stock dividends - \$0.22 per share                   | -                | -         | -        | -               | (5,358 )   | -                                 | (5,358 )             |
| Stock compensation expense                                  | -                | -         | -        | 740             | -          | -                                 | 740                  |
| Common stock issued pursuant to:                            |                  |           |          |                 |            |                                   |                      |
| Acquisition of CommerceFirst Bancorp, Inc. - 732,054 shares | -                | 732       | -        | 12,291          | -          | -                                 | 13,023               |
| Stock option plan - 1,217 shares                            | -                | 1         | -        | 14              | -          | -                                 | 15                   |
| Employee stock purchase plan - 16,341 shares                | -                | 17        | -        | 233             | -          | -                                 | 250                  |
| Director stock purchase plan - 1,083 shares                 | -                | 1         | -        | 18              | -          | -                                 | 19                   |
| Restricted stock - 44,987 shares                            | -                | 45        | -        | (391 )          | -          | -                                 | (346 )               |
| Balances at June 30, 2012                                   | \$ -             | \$ 24,887 | \$ -     | \$ 190,733      | \$ 241,267 | \$ 14,577                         | \$ 471,464           |
| Balances at January 1, 2011                                 | \$ -             | \$ 24,047 | \$ 3,699 | \$ 177,344      | \$ 205,099 | \$ (2,620 )                       | \$ 407,569           |
| Net income  | -                | -         | -        | -               | 15,587     | -                                 | 15,587               |
| Other comprehensive income, net of tax:                     | -                | -         | -        | -               | -          | 8,104                             | 8,104                |
| Common stock dividends - \$0.16 per share                   | -                | -         | -        | -               | (3,884 )   | -                                 | (3,884 )             |
| Stock compensation expense                                  | -                | -         | -        | 590             | -          | -                                 | 590                  |
| Stock warrant redemption                                    | -                | -         | (3,699 ) | (750 )          | -          | -                                 | (4,449 )             |
| Common stock issued pursuant to:                            |                  |           |          |                 |            |                                   |                      |
| Stock option plan - 1,765 shares                            | -                | 2         | -        | 19              | -          | -                                 | 21                   |
| Employee stock purchase plan - 16,448 shares                | -                | 16        | -        | 246             | -          | -                                 | 262                  |
| Director stock purchase plan - 1,833 shares                 | -                | 2         | -        | 30              | -          | -                                 | 32                   |
| Restricted stock - 28,450 shares                            | -                | 28        | -        | (176 )          | -          | -                                 | (148 )               |
| Balances at June 30, 2011                                   | \$ -             | \$ 24,095 | \$ -     | \$ 177,303      | \$ 216,802 | \$ 5,484                          | \$ 423,684           |

The accompanying notes are an integral part of these statements

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## **Sandy Spring Bancorp, Inc. and Subsidiaries**

Notes to the Consolidated Financial Statements - UNAUDITED

### **Note 1 – Significant Accounting Policies**

#### **Nature of Operations**

Sandy Spring Bancorp (the “Company”), a Maryland corporation, is the bank holding company for Sandy Spring Bank (the “Bank”), which conducts a full-service commercial banking, mortgage banking and trust business. Services to individuals and businesses include accepting deposits, extending real estate, consumer and commercial loans and lines of credit, equipment leasing, general insurance, personal trust, and investment and wealth management services. The Company operates in the six Maryland counties of Anne Arundel, Carroll, Frederick, Howard, Montgomery, and Prince George's, and in Arlington, Fairfax and Loudoun counties in Virginia. The Company offers investment and wealth management services through the Bank's subsidiary, West Financial Services. Insurance products are available to clients through Sandy Spring Insurance, and Neff & Associates, which are agencies of Sandy Spring Insurance Corporation.

#### **Basis of Presentation**

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (“GAAP”) and prevailing practices within the financial services industry for interim financial information and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required for complete financial statements and prevailing practices within the banking industry. The following summary of significant accounting policies of the Company is presented to assist the reader in understanding the financial and other data presented in this report. Operating results for the three and six months ended June 30, 2012 are not necessarily indicative of the results that may be expected for any future periods or for the year ending December 31, 2012. In the opinion of management, all adjustments (comprising only normal recurring accruals) necessary for a fair presentation of the results of the interim periods have been included. Certain reclassifications have been made to prior period amounts to conform to the current period presentation. The Company has evaluated subsequent events through the date of the issuance of its financial statements.

These statements should be read in conjunction with the financial statements and accompanying notes included in the Company's 2011 Annual Report on Form 10-K as filed with the Securities and Exchange Commission (“SEC”) on March 15, 2012. There have been no significant changes to the Company's accounting policies as disclosed in the 2011 Annual Report on Form 10-K.

#### **Principles of Consolidation**

The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Sandy Spring Bank and its subsidiaries, Sandy Spring Insurance Corporation and West Financial Services, Inc. Consolidation has resulted in the elimination of all significant intercompany accounts and transactions.

#### Use of Estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements, and affect the reported amounts of revenues earned and expenses incurred during the reporting period. Actual results could differ from those estimates. Estimates that could change significantly relate to the provision for loan and lease losses and the related allowance, determination of impaired loans and the related measurement of impairment, potential impairment of goodwill or other intangible assets, valuation of investment securities and the determination of whether impaired securities are other-than-temporarily impaired, valuation of other real estate owned, prepayment rates, valuation of share-based compensation, the assessment that a liability should be recognized with respect to any matters under litigation, the calculation of current and deferred income taxes and the actuarial projections related to pension expense and the related liability.

#### Cash Flows

For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks, federal funds sold and interest-bearing deposits with banks (items with an original maturity of three months or less).

### **Loans Acquired with Deteriorated Credit Quality**

Acquired loans are evaluated for evidence of credit deterioration since their origination as of the date of the acquisition are recorded at their initial fair value. Credit deterioration is determined based on the probability of collection of all contractually required principal and interest payments. The historical allowance for loan and lease losses related to the purchased loans is not carried over to the Company. The determination of credit quality deterioration as of the purchase date may include parameters such as past due and non-accrual status, commercial risk ratings, cash flow projections, type of loan and collateral, collateral value and recent loan-to-value ratios or appraised values. For loans acquired with no evidence of credit deterioration, the fair value discount or premium is amortized over the contractual life of the loan as an adjustment to yield. For loans acquired with evidence of credit deterioration, the Company determines at the acquisition date the excess of the loan's contractually required payments over all cash flows expected to be collected as an amount that should not be accreted into interest income (nonaccretable difference). The remaining amount representing the difference in the expected cash flows of acquired loans and the initial investment in the acquired loans is accreted into interest income over the remaining life of the loan or pool of loans (accretable yield). Subsequent to the purchase date, increases in expected cash flows over those expected at the purchase date are recognized prospectively as interest income over the remaining life of the loan. Increases in the present value of expected cash flows after the purchase date is recognized as an adjustment to the accretable yield. The present value of any decreases in expected cash flows after the purchase date is recognized as an impairment through a charge to the provision for loan losses. Subsequent to the purchase date, the methods utilized to estimate the required ALLL are similar to originated loans. Loans carried at fair value, mortgage loans held for sale and loans under revolving credit agreements are excluded from the scope of this guidance on loans acquired with deteriorated credit quality.

### **Adopted Accounting Pronouncements**

In June 2011, the FASB issued a standard that requires comprehensive income to be reported in either a single statement or two consecutive statements reporting net income and other comprehensive income. The guidance does not alter the items that are reported in other comprehensive income or require reclassification of items from other comprehensive income to net income. This guidance should be applied retrospectively and is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company has opted to present comprehensive income in two consecutive statements. This guidance did not have any impact on the financial position, results of operations or cash flows of the Company as it only affects the presentation of the information in the financial statements.

The FASB issued a standard in April 2011 that removed from the assessment of effective control the criterion relating to the transferor's ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee, as the criterion is not a determining factor of effective control. This guidance is effective for the first interim or annual period beginning on or after December 15, 2011. This guidance did not have a material impact on the financial position, results of operations or cash flows of the Company.

In May 2011, the FASB issued guidance on fair value that applies to all entities that measure assets, liabilities or instruments classified in stockholders' equity at fair value or provide fair value disclosures for items not recorded at fair value. The guidance clarifies how a principal market is determined, addresses the fair value measurement of instruments with offsetting market or counterparty credit risk and the concept of valuation premise and highest and best use, extends the prohibition of blockage factors to all three levels of the fair value hierarchy, and requires additional disclosures. This guidance is effective for interim and annual periods beginning after December 15, 2011. Differences in fair value measurement resulting from the application of the guidance will be recognized in income in the period of adoption as a change in estimate. Disclosure requirements will be recognized prospectively. Changes in valuation techniques and related inputs as a result of the application of the guidance in addition to an estimate of the total effect of the changes, if practicable, will be disclosed in the period of adoption. The application of this guidance did not have a significant impact on the financial position, results of operations or cash flows of the Company.

## **NOTE 2 – ACQUISITION**

On May 31, 2012, the Company completed the acquisition of CommerceFirst Bancorp, Inc. and its wholly-owned subsidiary. Under the terms of the acquisition the Company acquired 100% of the shares of CommerceFirst common stock for a combination of 50% Sandy Spring Bancorp common stock and 50% cash. Stock consideration was exchanged at a ratio of 0.8043 of the Company's shares for each CommerceFirst share resulting in the issuance of 732,054 of the Company's common stock. Total cash consideration amounted to \$12.4 million or \$13.60 per share.

The transaction has been accounted for using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed and consideration transferred were recorded at their estimated fair value on the acquisition date. Assets acquired amounted to \$190.9 million, including loans and leases of \$169.0 million. Liabilities assumed totaled \$170.6 million, including \$169.9 million in deposits. The acquisition resulted in the addition of \$13.0 million to the Company's equity. Goodwill of \$5.1 million was recorded as a result of the transaction and will not be deductible for tax purposes. The goodwill from this transaction will be included in the Company's Community Banking segment. The stock portion of the consideration to CommerceFirst shareholders is intended to qualify as a tax-free transaction.

The consideration transferred for CommerceFirst's common equity and the amounts of acquired identifiable assets and liabilities assumed as of the acquisition date were as follows:

|   |           |
|---|-----------|
| (in thousands)                          |           |
| Purchase Price:                         |           |
| Value of common share issued            | \$ 13,023 |
| Cash                                    | 12,381    |
| Total purchase price                    | 25,404    |
| Identifiable assets:                    |           |
| Cash and due from banks                 | 11,532    |
| Investments                             | 502       |
| Loans and leases                        | 168,984   |
| Other Real Estate Owned                 | 4,232     |
| Intangible assets                       | 210       |
| Other assets                            | 5,439     |
| Total identifiable assets               | 190,899   |
| Liabilities:                            |           |
| Deposits                                | 169,921   |
| Other Liabilities                       | 644       |
| Total liabilities                       | 170,565   |
| Net goodwill resulting from acquisition | \$ 5,070  |

The determination of the fair value of acquired assets and assumed liabilities required that expected cash flows from those assets and liabilities be estimated and discounted at appropriate rates of interest. The most significant of these determinations related to the valuation of acquired loans with evidence of deteriorated credit quality. The following is a summary of the loans acquired in the acquisition with evidence of deteriorated credit quality:

Loans  
Acquired

| (in thousands)  | with<br>Evidence of<br>Deteriorated<br>Credit<br>Quality |
|---|--|
| Contractually required principal and interest at acquisition  | \$ 11,356  |
| Contractual cash flows not expected to be collected           | (4,427 )   |
| Expected cash flows at acquisition                            | 6,929  |
| Interest component of expected cash flows                     | (850 )   |
| Basis in acquired loans at acquisition - estimated fair value | \$ 6,079   |

The fair value of checking, savings and money market deposit accounts acquired was assumed to be the carrying value as these accounts have no stated maturity and are payable on demand. Certificate of deposit accounts were valued at the present value of the expected contractual payments discounted at the market rates for similar certificates. There was no core deposit intangible associated with the acquisition of the deposits.

Merger related expenses associated with the acquisition related to personnel and integrating and conforming the acquired operations with and into the Company. These expenses consisted of professional services, conversion and integration of operations, termination of existing contractual arrangements and cost to provide an introduction of the Company to its new customers. A summary of merger related expenses included in the indicated captions in the consolidated statement of income at June 30, 2012 as follows:

|   |   |
|---|---|
|   | For the<br>Six<br>Months<br>Ended<br>June 30,<br>2012 |
| <i>(in thousands)</i>                       |   |
| Salaries and employee benefits              | \$ 737  |
| Outside data services                       | 1,031   |
| Other non-interest expenses:                |   |
| Professional fees (legal, consulting, etc.) | 683   |
| Miscellaneous expenses                      | 121   |
| Total merger expenses                       | \$ 2,572  |

### Pro Forma Condensed Combined Financial Information

If the acquisition of CommerceFirst had been completed on January 1, 2011, total revenue, net of interest expense, would have been approximately \$85.8 million and \$82.6 million for the six months ended June 30, 2012 and 2011, respectively. Net income would have been approximately \$16.1 million and \$16.5 million for the same periods. The pro forma information does not provide for the impact of potential business model revisions nor does it consider any potential impacts of current market conditions on revenue, expense efficiencies or other factors.

### Note 3 – Investments

#### Investments available-for-sale

The amortized cost and estimated fair values of investments available-for-sale at the dates indicated are presented in the following table:

|                                 | At June 30, 2012  |                              |                               |                            | At December 31, 2011 |                              |                               |                            |
|---------------------------------|-------------------|------------------------------|-------------------------------|----------------------------|----------------------|------------------------------|-------------------------------|----------------------------|
|                                 | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value | Amortized<br>Cost    | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
| (In thousands)                  |                   |                              |                               |                            |                      |                              |                               |                            |
| U.S. government agencies        | \$ 120,027        | \$ 1,593                     | \$ -                          | \$ 121,620                 | \$ 197,816           | \$ 2,436                     | \$ -                          | \$ 200,252                 |
| State and municipal             | 159,144           | 12,575                       | (13 )                         | 171,706                    | 160,657              | 12,456                       | (2 )                          | 173,111                    |
| Mortgage-backed                 | 488,647           | 20,924                       | (37 )                         | 509,534                    | 551,518              | 18,639                       | (13 )                         | 570,144                    |
| Corporate debt                  | 2,000             | -                            | (5 )                          | 1,995                      | 2,000                | -                            | (22 )                         | 1,978                      |
| Trust preferred                 | 3,554             | 164                          | (415 )                        | 3,303                      | 5,936                | 260                          | (480 )                        | 5,716                      |
| Total debt securities           | 773,372           | 35,256                       | (470 )                        | 808,158                    | 917,927              | 33,791                       | (517 )                        | 951,201                    |
| Marketable equity<br>securities | 723               | -                            | -                             | 723                        | 100                  | -                            | -                             | 100                        |
|                                 | \$ 774,095        | \$ 35,256                    | \$ (470 )                     | \$ 808,881                 | \$ 918,027           | \$ 33,791                    | \$ (517 )                     | \$ 951,301                 |

Total investments  
available-for-sale

Any unrealized losses in the U.S. government agencies, state and municipal, mortgage-backed or corporate debt investment securities at June 30, 2012 are the result of changes in interest rates and are not considered credit related. These declines are considered temporary in nature and will decline over time and recover as these securities approach maturity.

The mortgage-backed portfolio at June 30, 2012 is composed entirely of either the most senior tranches of GNMA collateralized mortgage obligations (\$208.5 million), or GNMA, FNMA or FHLMC mortgage-backed securities (\$301.0 million). The Company does not intend to sell these securities and has sufficient liquidity to hold these securities for an adequate period of time, which may be maturity, to allow for any anticipated recovery in fair value.

At June 30, 2012, the trust preferred portfolio consisted of one security backed by a single financial institution issuer and one pooled trust preferred security. The fair value of the single issue security was \$1.5 million as determined using broker quotations. The pooled trust preferred security is backed by debt issued by banks and thrifts, which totals \$2.2 million, with a fair value of \$1.8 million. The fair value of this security was determined by a third party valuation specialist due to the limited trading activity for this security in the marketplace.

The specialist used an income valuation approach technique (present value) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. The methodology and significant assumptions employed by the specialist to determine fair value included:

- Evaluation of the structural terms as established in the indenture;



- Detailed credit and structural evaluation for each piece of issuer collateral in the pool;
- Overall default (.30%), recovery and prepayment (2%)/amortization probabilities by issuers in the pool;
- Identification of adverse conditions specifically related to the security, industry and geographical area;
- Projection of estimated cash flows that incorporate default expectations and loss severities;
  - Review of historical and implied volatility of the fair value of the security;
- Evaluation of credit risk concentrations;
- Evaluation of the length of time and the extent to which the fair value has been less than the amortized cost; and
- A discount rate of 12.6% was established using credit adjusted financial institution spreads for comparably rated institutions and a liquidity adjustment that considered the previously noted characteristics.

As a result of this evaluation, it was determined that the pooled trust preferred security incurred credit-related other-than-temporary impairment (“OTTI”) of \$8 thousand, which was recognized in earnings for the quarter ended June 30, 2012. For the six months ended June 30, 2012 the OTTI recognized in earnings was \$72 thousand. Non-credit related OTTI on this security, which is not expected to be sold and that the Company has the ability to hold until maturity, was \$0.4 million at June 30, 2012. This non-credit related OTTI was recognized in other comprehensive income (“OCI”) at June 30, 2012.

The methodology and significant inputs used to measure the amount related to credit loss consisted of the following:

- Default rates were developed based on the financial condition of the trust preferred issuers in the pool and the payment or deferral status. Conditional default rates were estimated based on the payment characteristics of the security and the financial condition of the issuers in the pool. Near term and future defaults are estimated using third party industry data in addition to a review of key financial ratios and other pertinent data on the financial stability of the underlying issuer;
- Loss severity is forecasted based on the type of impairment using research performed by third parties;
- The security contains one level of subordination below the senior tranche, with the senior tranche receiving the spread from the subordinate bonds. Given recent performance, it is not expected that the senior tranche will receive its full interest and principal at the bond’s maturity date;
- Credit ratings of the underlying issuers are reviewed in conjunction with the development of the default rates applied to determine the credit amounts related to the credit loss; and
- Potential prepayments are estimated based on terms and rates of the underlying trust preferred securities to determine the impact of excess spread on the credit enhancement, the removal of the strongest institutions from the underlying pool and any impact that prepayments might have on diversity and concentration.

The following table provides the activity of OTTI on investment securities due to credit losses recognized in earnings for the period indicated:

|                |             |     |
|----------------|-------------|-----|
| (In thousands) | OTTI Losses |     |
|                | \$          | 422 |

|  |    |     |
|--|----|-----|
| Cumulative credit losses<br>on investment securities,<br>through January 1, 2012 |    |     |
| Additions for credit<br>losses not previously<br>recognized                      |    | 72  |
| Cumulative credit losses<br>on investment securities,<br>through June 30, 2012   | \$ | 494 |

Gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in an unrealized loss position at the dates indicated are presented in the following table:

At June 30, 2012

| (Dollars in thousands) | Number of securities | Fair Value | Continuous Unrealized Losses Existing for: |                     | Total Unrealized Losses |
|------------------------|----------------------|------------|--|---------------------|-------------------------|
|                        |                      |            | Less than 12 months                        | More than 12 months |                         |
| State and municipal    | 2                    | \$ 1,176   | \$ 13                                      | \$ -                | \$ 13                   |
| Mortgage-backed        | 2                    | 7,073      | 37   | -                   | 37                      |
| Corporate debt         | 1                    | 1,995      | 5  | -                   | 5                       |
| Trust preferred        | 1                    | 1,817      | -  | 415                 | 415                     |
| Total                  | 6                    | \$ 12,061  | \$ 55                                      | \$ 415              | \$ 470                  |

At December 31, 2011

| (Dollars in thousands) | Number of securities | Fair Value | Continuous Unrealized Losses Existing for: |                     | Total Unrealized Losses |
|------------------------|----------------------|------------|--|---------------------|-------------------------|
|                        |                      |            | Less than 12 months                        | More than 12 months |                         |
| State and municipal    | 1                    | \$ 397     | \$ 2                                       | \$ -                | \$ 2                    |
| Mortgage-backed        | 3                    | 5,081      | 13   | -                   | 13                      |
| Corporate debt         | 1                    | 3,326      | 22   | -                   | 22                      |
| Trust preferred        | 1                    | 2,467      | -  | 480                 | 480                     |
| Total                  | 6                    | \$ 11,271  | \$ 37                                      | \$ 480              | \$ 517                  |

The amortized cost and estimated fair values of investment securities available-for-sale by contractual maturity at the dates indicated are provided in the following table. The Company has allocated mortgage-backed securities into the four maturity groupings reflected in the following table using the expected average life of the individual securities based on statistics provided by independent third party industry sources. Expected maturities will differ from contractual maturities as borrowers may have the right to prepay obligations with or without prepayment penalties.

| (In thousands)                           | At June 30, 2012 |                      | At December 31, 2011 |                      |
|--|------------------|----------------------|----------------------|----------------------|
|  | Amortized Cost   | Estimated Fair Value | Amortized Cost       | Estimated Fair Value |
| Due in one year or less                  | \$20,284         | \$20,381             | \$65,569             | \$65,972             |
| Due after one year through five years    | 37,844           | 39,045               | 62,993               | 64,656               |
| Due after five years through ten years   | 311,158          | 324,495              | 342,813              | 354,238              |
| Due after ten years                      | 404,086          | 424,237              | 446,552              | 466,335              |
| Total debt securities available for sale | \$773,372        | \$808,158            | \$917,927            | \$951,201            |

At June 30, 2012 and December 31, 2011, investments available-for-sale with a book value of \$221.2 million and \$255.4 million, respectively, were pledged as collateral for certain government deposits and for other purposes as required or permitted by law. The outstanding balance of no single issuer, except for U.S. Agencies securities, exceeded ten percent of stockholders' equity at June 30, 2012 and December 31, 2011.



Investments held-to-maturity

The amortized cost and estimated fair values of investments held-to-maturity at the dates indicated are presented in the following table:

| (In thousands)                     | At June 30, 2012 |             |              |                      | At December 31, 2011 |             |              |                      |
|------------------------------------|------------------|-------------|--------------|----------------------|----------------------|-------------|--------------|----------------------|
|                                    | Amortized Cost   | Gross Gains | Gross Losses | Estimated Fair Value | Amortized Cost       | Gross Gains | Gross Losses | Estimated Fair Value |
| U.S. government agencies           | \$37,576         | \$ 37       | \$ (140 )    | \$37,473             | \$54,983             | \$ 406      | \$ -         | \$55,389             |
| State and municipal                | 126,904          | 4,883       | (277 )       | 131,510              | 123,075              | 5,244       | (1 )         | 128,318              |
| Mortgage-backed                    | 366              | 47          | -            | 413                  | 407                  | 53          | -            | 460                  |
| Total investments held-to-maturity | \$164,846        | \$ 4,967    | \$ (417 )    | \$169,396            | \$178,465            | \$ 5,703    | \$ (1 )      | \$184,167            |

Gross unrealized losses and fair value by length of time that the individual held-to-maturity securities have been in a continuous unrealized loss position at the dates indicated are presented in the following tables:

| (Dollars in thousands)   | Number of securities | Fair Value | Continuous Unrealized Losses Existing for: |                     | Total Unrealized Losses |
|--------------------------|----------------------|------------|--|---------------------|-------------------------|
|                          |                      |            | Less than 12 months                        | More than 12 months |                         |
| U.S. government agencies | 3                    | \$ 17,435  | \$ 140                                     | \$ -                | \$ 140                  |
| State and municipal      | 20                   | 20,624     | 277  | -                   | 277                     |
| Total                    | 23                   | \$ 38,059  | \$ 417                                     | \$ -                | \$ 417                  |

| (Dollars in thousands) | Number of securities | Fair Value | Continuous Unrealized Losses Existing for: |                     | Total Unrealized Losses |
|------------------------|----------------------|------------|--|---------------------|-------------------------|
|                        |                      |            | Less than 12 months                        | More than 12 months |                         |
| State and municipal    | 1                    | \$ 541     | \$ 1                                       | \$ -                | \$ 1                    |
| Total                  | 1                    | \$ 541     | \$ 1                                       | \$ -                | \$ 1                    |

The Company does not intend to sell these securities and has sufficient liquidity to hold these securities for an adequate period of time, which may be maturity, to allow for any anticipated recovery in fair value, and substantiates that the unrealized losses in the held-to-maturity portfolio are considered temporary in nature.

The amortized cost and estimated fair values of debt securities held-to-maturity by contractual maturity at the dates indicated are reflected in the following table. Expected maturities will differ from contractual maturities as borrowers may have the right to prepay obligations with or without prepayment penalties.

|  | At June 30, 2012 |                      | At December 31, 2011 |                      |
|--|------------------|----------------------|----------------------|----------------------|
|  | Amortized Cost   | Estimated Fair Value | Amortized Cost       | Estimated Fair Value |
| (In thousands)                         |                  |                      |                      |                      |
| Due in one year or less                | \$11,939         | \$12,168             | \$18,860             | \$19,203             |
| Due after one year through five years  | 5,605            | 5,731                | 6,937                | 7,144                |
| Due after five years through ten years | 80,110           | 82,340               | 98,428               | 101,008              |
| Due after ten years                    | 67,192           | 69,157               | 54,240               | 56,812               |
| Total debt securities held-to-maturity | \$164,846        | \$169,396            | \$178,465            | \$184,167            |

At June 30, 2012 and December 31, 2011, investments held-to-maturity with a book value of \$130.3 million and \$58.7 million, respectively, were pledged as collateral for certain government deposits and for other purposes as required or permitted by law. The outstanding balance of no single issuer, except for U.S. Agency securities, exceeded ten percent of stockholders' equity at June 30, 2012 and December 31, 2011.

#### Equity securities

Other equity securities at the dates indicated are presented in the following table:

| (In thousands)                          | June 30, 2012 | December 31, 2011 |
|---|---------------|-------------------|
| Federal Reserve Bank stock              | \$ 8,292      | \$ 7,530          |
| Federal Home Loan Bank of Atlanta stock | 24,724        | 27,328            |
| Other equities                          | -             | 75                |
| Total equity securities                 | \$ 33,016     | \$ 34,933         |

#### Note 4 – Loans and Leases

Outstanding loan balances at June 30, 2012 and December 31, 2011 are net of unearned income including net deferred loan costs of \$2.7 million and \$2.0 million, respectively. The loan portfolio segment balances at the dates indicated are presented in the following table:

| (In thousands)                                       | June 30, 2012 | December 31, 2011 |
|--|---------------|-------------------|
| Residential real estate:                             |               |                   |
| Residential mortgage                                 | \$ 472,426    | \$ 448,662        |
| Residential construction                             | 130,791       | 108,699           |
| Commercial real estate:                              |               |                   |
| Commercial owner occupied real estate                | 579,812       | 522,076           |
| Commercial investor real estate                      | 443,237       | 371,948           |
| Commercial acquisition, development and construction | 151,620       | 160,946           |
| Commercial Business                                  | 334,040       | 260,327           |
| Leases   | 5,618         | 6,954             |
| Consumer   | 357,534       | 360,080           |
| Total loans and leases                               | \$ 2,475,078  | \$ 2,239,692      |

**Note 5 – CREDIT QUALITY ASSESSMENT**

**Allowance for Loan and Lease Losses**

Summary information on the allowance for loan and lease loss activity for the period indicated is provided in the following table:

| (In thousands)                      | Six Months Ended June 30, |           |
|-------------------------------------|---------------------------|-----------|
|                                     | 2012                      | 2011      |
| Balance at beginning of year        | \$ 49,426                 | \$ 62,135 |
| Provision for loan and lease losses | 2,249                     | 2,666     |
| Loan and lease charge-offs          | (7,343 )                  | (10,254 ) |
| Loan and lease recoveries           | 933                       | 699       |
| Net charge-offs                     | (6,410 )                  | (9,555 )  |
| Balance at period end               | \$ 45,265                 | \$ 55,246 |

The following tables provide information on the activity in the allowance for loan and lease losses by the respective loan portfolio segment for the period indicated:

| (Dollars in thousands)   | For the Six Months Ended June 30, 2012 |                 |                     |                               |                        |                         |                      |                          |            |             |
|--|--|-----------------|---------------------|-------------------------------|------------------------|-------------------------|----------------------|--------------------------|------------|-------------|
|  | Commercial Real Estate                 |                 |                     |                               |                        | Residential Real Estate |                      |                          |            |             |
|  | Commercial Business                    | Commercial AD&C | Commercial Investor | Commercial Owner R/E Occupied | Commercial R/E Leasing | Consumer                | Residential Mortgage | Residential Construction | Commercial | Residential |
| Balance at beginning of year                                   | \$6,727                                | \$6,664         | \$8,248             | \$7,329                       | \$795                  | \$4,873                 | \$10,583             | \$4,207                  | \$4,207    | \$4,207     |
| Provision (credit)   | (1,697 )                               | (101 )          | 4,979               | 160                           | (236 )                 | (25 )                   | 284                  | (1,115 )                 | 284        | (1,115 )    |
| Charge-offs  | (354 )                                 | (1,076 )        | (3,457 )            | (493 )                        | (6 )                   | (697 )                  | (1,193 )             | (67 )                    | (67 )      | (67 )       |
| Recoveries   | 578                                    | 59              | 98                  | 9                             | 4                      | 121                     | 60                   | 4                        | 4          | 4           |
| Net charge-offs  | 224                                    | (1,017 )        | (3,359 )            | (484 )                        | (2 )                   | (576 )                  | (1,133 )             | (63 )                    | (63 )      | (63 )       |
| Balance at end of period                                       | \$5,254                                | \$5,546         | \$9,868             | \$7,005                       | \$557                  | \$4,272                 | \$9,734              | \$3,029                  | \$3,029    | \$3,029     |
| Total loans and leases   | \$334,040                              | \$151,620       | \$443,237           | \$579,812                     | \$5,618                | \$357,534               | \$472,426            | \$130,791                | \$130,791  | \$130,791   |
| Allowance for loans and leases to total loans and leases ratio | 1.57 %                                 | 3.66 %          | 2.23 %              | 1.21 %                        | 9.91 %                 | 1.19 %                  | 2.06 %               | 2.32 %                   | 2.32 %     | 1.57 %      |
| Balance of loans specifically evaluated for impairment         | \$7,739                                | \$13,055        | \$14,143            | \$16,970                      | na.                    | \$34                    | \$4,896              | \$741                    | \$741      | \$741       |
| Allowance for loans specifically evaluated                     | \$753                                  | \$973           | \$276               | \$1,336                       | na.                    | na.                     | \$1,389              | \$159                    | \$159      | \$159       |



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|   |           |   |           |   |           |   |           |   |         |           |           |   |           |   |     |
|---|-----------|---|-----------|---|-----------|---|-----------|---|---------|-----------|-----------|---|-----------|---|-----|
| for impairment<br>Specific allowance to<br>specific loans ratio | 9.73      | % | 0.00      | % | 1.95      | % | 7.87      | % | na.     | na.       | 28.37     | % | 21.46     | % | 8   |
| Balance of loans<br>collectively evaluated                      | \$326,301 |   | \$138,565 |   | \$429,094 |   | \$562,842 |   | \$5,618 | \$357,500 | \$467,530 |   | \$130,050 |   | \$2 |
| Allowance for loans<br>collectively evaluated                   | \$4,501   |   | \$4,573   |   | \$9,592   |   | \$5,669   |   | \$557   | \$4,272   | \$8,345   |   | \$2,870   |   | \$4 |
| Collective allowance<br>to collective loans<br>ratio            | 1.38      | % | 3.30      | % | 2.24      | % | 1.01      | % | 9.91    | %         | 1.19      | % | 1.78      | % | 1   |

For the Year Ended December 31, 2011

| (Dollars in thousands)   | Commercial Real Estate |           |              |                  |         |           | Residential Real Estate |                             |       |     |       |   |       |   |      |   |
|--|------------------------|-----------|--------------|------------------|---------|-----------|-------------------------|-----------------------------|-------|-----|-------|---|-------|---|------|---|
|  | Commercial             |           |              | Commercial Owner |         |           | Residential<br>Mortgage | Residential<br>Construction | T     |     |       |   |       |   |      |   |
|  | Business               | AD&C      | Investor R/E | Occupied R/E     | Leasing | Consumer  |                         |                             |       |     |       |   |       |   |      |   |
| Balance at beginning<br>of year                                      | \$12,870               | \$18,241  | \$4,793      | \$8,177          | \$667   | \$4,231   | \$10,396                | \$2,760                     | \$    |     |       |   |       |   |      |   |
| Provision (credit)   | (4,252 )               | (11,035 ) | 4,320        | (361 )           | 1,182   | 3,173     | 5,144                   | 3,257                       |       |     |       |   |       |   |      |   |
| Charge-offs  | (2,565 )               | (1,780 )  | (868 )       | (487 )           | (1,072) | (2,740 )  | (5,178 )                | (1,815 )                    |       |     |       |   |       |   |      |   |
| Recoveries   | 674                    | 1,238     | 3            | -                | 18      | 209       | 221                     | 5                           |       |     |       |   |       |   |      |   |
| Net charge-offs  | (1,891 )               | (542 )    | (865 )       | (487 )           | (1,054) | (2,531 )  | (4,957 )                | (1,810 )                    |       |     |       |   |       |   |      |   |
| Balance at end of year   | \$6,727                | \$6,664   | \$8,248      | \$7,329          | \$795   | \$4,873   | \$10,583                | \$4,207                     | \$    |     |       |   |       |   |      |   |
| Total loans and leases   | \$260,327              | \$160,946 | \$371,948    | \$522,076        | \$6,954 | \$360,080 | \$448,662               | \$108,699                   | \$    |     |       |   |       |   |      |   |
| Allowance for loans<br>and leases to total<br>loans and leases ratio | 2.58                   | %         | 4.14         | %                | 2.22    | %         | 1.40                    | %                           | 11.43 | %   | 1.35  | % | 2.36  | % | 3.87 | % |
| Balance of loans<br>specifically evaluated<br>for impairment         | \$9,092                | \$18,701  | \$16,964     | \$15,416         | na.     | \$35      | \$5,108                 | \$2,259                     | \$    |     |       |   |       |   |      |   |
| Allowance for loans<br>specifically evaluated<br>for impairment      | \$1,037                | \$7       | \$3,380      | \$1,772          | na.     | na.       | \$769                   | \$826                       | \$    |     |       |   |       |   |      |   |
| Specific allowance to<br>specific loans ratio                        | 11.41                  | %         | 0.04         | %                | 19.92   | %         | 11.49                   | %                           | na.   | na. | 15.05 | % | 36.56 | % |      |   |
| Balance of loans<br>collectively evaluated                           | \$251,235              | \$142,245 | \$354,984    | \$506,660        | \$6,954 | \$360,045 | \$443,554               | \$106,440                   | \$    |     |       |   |       |   |      |   |
| Allowance for loans<br>collectively evaluated                        | \$5,690                | \$6,657   | \$4,868      | \$5,557          | \$795   | \$4,873   | \$9,814                 | \$3,381                     | \$    |     |       |   |       |   |      |   |
| Collective allowance<br>to collective loans<br>ratio                 | 2.26                   | %         | 4.68         | %                | 1.37    | %         | 1.10                    | %                           | 11.43 | %   | 1.35  | % | 2.21  | % | 3.18 | % |

The following table provides summary information regarding impaired loans at the dates indicated and for the periods then ended:

| (In thousands)  | June 30,<br>2012 | December 31,<br>2011 |
|---|------------------|----------------------|
| Impaired loans with a valuation allowance                                   | \$22,669         | \$ 36,742            |
| Impaired loans without a valuation allowance                                | 34,908           | 30,833               |
| Total impaired loans  | \$57,577         | \$ 67,575            |
| Allowance for loan and lease losses related to impaired loans               | \$4,886          | \$ 7,791             |
| Allowance for loan and lease losses related to loans collectively evaluated | 40,379           | 41,635               |
| Total allowance for loan and lease losses                                   | \$45,265         | \$ 49,426            |
| Average impaired loans for the period                                       | \$62,336         | \$ 68,377            |
| Contractual interest income due on impaired loans during the period         | \$2,511          | \$ 4,973             |
| Interest income on impaired loans recognized on a cash basis                | \$666            | \$ 1,523             |
| Interest income on impaired loans recognized on an accrual basis            | \$224            | \$ 325               |

The following tables present the recorded investment with respect to impaired loans, the associated allowance by the applicable portfolio segment and the principal balance of the impaired loans prior to amounts charged-off at the dates indicated:

| (In thousands)                                     | At June 30, 2012       |                 |                         |                               |                 | Total Recorded Investment in Impaired Loans |
|--|------------------------|-----------------|-------------------------|-------------------------------|-----------------|---|
|  | Commercial Real Estate |                 |                         |                               |                 |   |
|  | Commercial             | Commercial AD&C | Commercial Investor R/E | Commercial Owner Occupied R/E | All Other Loans |   |
| <b>Impaired loans with a specific allowance</b>    |                        |                 |                         |                               |                 |   |
| Non-accruing                                       | \$ 848                 | \$ -            | \$ 996                  | \$ 5,909                      | \$ 221          | \$ 7,974                                    |
| Restructured accruing                              | 1,527                  | -               | -                       | 1,331                         | 3,453           | 6,311                                       |
| Restructured non-accruing                          | 198                    | 4,679           | 179                     | 2,951                         | 377             | 8,384                                       |
| Balance  | \$ 2,573               | \$ 4,679        | \$ 1,175                | \$ 10,191                     | \$ 4,051        | \$ 22,669                                   |
| Allowance  | \$ 753                 | \$ 973          | \$ 276                  | \$ 1,336                      | \$ 1,548        | \$ 4,886                                    |
| <b>Impaired loans without a specific allowance</b> |                        |                 |                         |                               |                 |   |
| Non-accruing                                       | \$ 1,863               | \$ 5,073        | \$ 11,951               | \$ 5,751                      | \$ -            | \$ 24,638                                   |
| Restructured accruing                              | 948                    | -               | -                       | 202                           | 824             | 1,974                                       |
| Restructured non-accruing                          | 2,355                  | 3,303           | 1,017                   | 826                           | 795             | 8,296                                       |
| Balance  | \$ 5,166               | \$ 8,376        | \$ 12,968               | \$ 6,779                      | \$ 1,619        | \$ 34,908                                   |
| Total impaired loans                               |                        |                 |                         |                               |                 |   |
| Non-accruing                                       | \$ 2,711               | \$ 5,073        | \$ 12,947               | \$ 11,660                     | \$ 221          | \$ 32,612                                   |
| Restructured accruing                              | 2,475                  | -               | -                       | 1,533                         | 4,277           | 8,285                                       |
| Restructured non-accruing                          | 2,553                  | 7,982           | 1,196                   | 3,777                         | 1,172           | 16,680                                      |
| Balance  | \$ 7,739               | \$ 13,055       | \$ 14,143               | \$ 16,970                     | \$ 5,670        | \$ 57,577                                   |
| Unpaid principal balance in total impaired loans   | \$ 10,102              | \$ 32,652       | \$ 17,986               | \$ 19,093                     | \$ -            | \$ 79,833                                   |

| (In thousands)  | For the Six Months Ended June 30, 2012 |                 |                         |                               |                 | Total Recorded Investment in Impaired Loans |
|---|--|-----------------|-------------------------|-------------------------------|-----------------|---|
|   | Commercial Real Estate                 |                 |                         |                               |                 |   |
|   | Commercial                             | Commercial AD&C | Commercial Investor R/E | Commercial Owner Occupied R/E | All Other Loans |   |
| Average impaired loans for the period                               | \$ 8,630                               | \$ 15,353       | \$ 15,000               | \$ 16,806                     | \$ 6,546        | \$ 62,336                                   |
| Contractual interest income due on impaired loans during the period | \$ 276                                 | \$ 687          | \$ 653                  | \$ 733                        | \$ 162          |   |
| Interest income on impaired loans recognized on a cash basis        | \$ 108                                 | \$ 203          | \$ 48                   | \$ 289                        | \$ 18           |   |
| Interest income on impaired loans recognized on an accrual basis    | \$ 73                                  | \$ -            | \$ -                    | \$ 52                         | \$ 99           |   |



| (In thousands)                                     | At December 31, 2011   |                 |                         |                               |                 | Total Recorded Investment in Impaired Loans |
|--|------------------------|-----------------|-------------------------|-------------------------------|-----------------|---|
|  | Commercial Real Estate |                 |                         |                               |                 |   |
|  | Commercial             | Commercial AD&C | Commercial Investor R/E | Commercial Owner Occupied R/E | All Other Loans |   |
| Impaired loans <i>with</i> a specific allowance    |                        |                 |                         |                               |                 |   |
| Non-accruing                                       | \$ 1,110               | \$-             | \$ 13,812               | \$ 4,091                      | \$ 1,093        | \$ 20,106                                   |
| Restructured accruing                              | 1,346                  | -               | -                       | 707                           | 3,475           | 5,528                                       |
| Restructured non-accruing                          | 307                    | 6,504           | 628                     | 3,282                         | 387             | 11,108                                      |
| Balance  | \$ 2,763               | \$ 6,504        | \$ 14,440               | \$ 8,080                      | \$ 4,955        | \$ 36,742                                   |
| Allowance  | \$ 1,037               | \$ 7            | \$ 3,380                | \$ 1,772                      | \$ 1,595        | \$ 7,791                                    |
| Impaired loans <i>without</i> a specific allowance |                        |                 |                         |                               |                 |   |
| Non-accruing                                       | \$ 3,416               | \$ 7,798        | \$ 1,883                | \$ 6,464                      | \$ 800          | \$ 20,361                                   |
| Restructured accruing                              | 520                    | -               | -                       | -                             | 833             | 1,353                                       |
| Restructured non-accruing                          | 2,393                  | 4,399           | 641                     | 872                           | 814             | 9,119                                       |
| Balance  | \$ 6,329               | \$ 12,197       | \$ 2,524                | \$ 7,336                      | \$ 2,447        | \$ 30,833                                   |
| Total impaired loans                               |                        |                 |                         |                               |                 |   |
| Non-accruing                                       | \$ 4,526               | \$ 7,798        | \$ 15,695               | \$ 10,555                     | \$ 1,893        | \$ 40,467                                   |
| Restructured accruing                              | 1,866                  | -               | -                       | 707                           | 4,308           | 6,881                                       |
| Restructured non-accruing                          | 2,700                  | 10,903          | 1,269                   | 4,154                         | 1,201           | 20,227                                      |
| Balance  | \$ 9,092               | \$ 18,701       | \$ 16,964               | \$ 15,416                     | \$ 7,402        | \$ 67,575                                   |
| Unpaid principal balance in total impaired loans   | \$ 11,303              | \$ 37,442       | \$ 17,389               | \$ 16,466                     | \$-             | \$ 82,600                                   |

| (In thousands)  | For the Year Ended December 31, 2011 |                 |                         |                               |                 | Total Recorded Investment in Impaired Loans |
|---|--------------------------------------|-----------------|-------------------------|-------------------------------|-----------------|---|
|   | Commercial Real Estate               |                 |                         |                               |                 |   |
|   | Commercial                           | Commercial AD&C | Commercial Investor R/E | Commercial Owner Occupied R/E | All Other Loans |   |
| Average impaired loans for the period                               | \$ 9,800                             | \$ 27,005       | \$ 11,409               | \$ 13,942                     | \$ 6,221        | \$ 68,377                                   |
| Contractual interest income due on impaired loans during the period | \$ 583                               | \$ 1,743        | \$ 830                  | \$ 800                        | \$ 1,017        |   |
| Interest income on impaired loans recognized on a cash basis        | \$ 267                               | \$ 487          | \$ 93                   | \$ 471                        | \$ 205          |   |
| Interest income on impaired loans recognized on an accrual basis    | \$ 114                               | \$-             | \$-                     | \$ 45                         | \$ 166          |   |

### Credit Quality

The following tables provide information on the credit quality of the loan portfolio by segment at the dates indicated:

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June 30, 2012

| (In thousands)                        | Commercial Real Estate |          |              |                               |                  | Residential Real Estate |              |         |          |
|---------------------------------------|------------------------|----------|--------------|-------------------------------|------------------|-------------------------|--------------|---------|----------|
|                                       | Commercial             |          |              |                               |                  | Residential             |              |         |          |
|                                       | Commercial             | AD&C     | Investor R/E | Commercial Owner Occupied R/E | Leasing Consumer | Mortgage                | Construction | Total   |          |
| Non-performing loans and assets:      |                        |          |              |                               |                  |                         |              |         |          |
| Non-accrual loans and leases          | \$4,583                | \$13,055 | \$13,327     | \$15,146                      | \$872            | \$1,651                 | \$2,600      | \$4,333 | \$55,567 |
| Loans and leases 90 days past due     | 70                     | 342      | -            | -                             | 96               | 5                       | 91           | -       | 604      |
| Restructured loans and leases         | 2,475                  | -        | -            | 1,533                         | -                | 33                      | 4,244        | -       | 8,285    |
| Total non-performing loans and leases | 7,128                  | 13,397   | 13,327       | 16,679                        | 968              | 1,689                   | 6,935        | 4,333   | 64,456   |
| Other real estate owned               | 1,829                  | -        | 462          | 4,569                         | -                | -                       | 1,813        | 880     | 9,553    |
| Total non-performing assets           | \$8,957                | \$13,397 | \$13,789     | \$21,248                      | \$968            | \$1,689                 | \$8,748      | \$5,213 | \$74,009 |

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| (In thousands)                        | December 31, 2011      |            |              |                  |              |                         |          |                          |          |
|---------------------------------------|------------------------|------------|--------------|------------------|--------------|-------------------------|----------|--------------------------|----------|
|                                       | Commercial Real Estate |            |              |                  |              | Residential Real Estate |          |                          |          |
|                                       | Commercial             | Commercial |              |                  |              | Consumer                | Mortgage | Residential Construction | Total    |
|                                       |                        | AD&C       | Investor R/E | Commercial Owner | Occupied R/E |                         |          |                          |          |
| Non-performing loans and assets:      |                        |            |              |                  |              |                         |          |                          |          |
| Non-accrual loans and leases          | \$7,226                | \$18,702   | \$16,963     | \$14,709         | \$853        | \$1,786                 | \$5,722  | \$5,719                  | \$71,680 |
| Loans and leases 90 days past due     | -                      | -          | -            | -                | 2            | 165                     | 167      | 243                      | 577      |
| Restructured loans and leases         | 1,866                  | -          | -            | 707              | -            | 35                      | 3,579    | 694                      | 6,881    |
| Total non-performing loans and leases | 9,092                  | 18,702     | 16,963       | 15,416           | 855          | 1,986                   | 9,468    | 6,656                    | 79,138   |
| Other real estate owned               | 100                    | -          | 462          | 273              | -            | -                       | 3,395    | 201                      | 4,431    |
| Total non-performing assets           | \$9,192                | \$18,702   | \$17,425     | \$15,689         | \$855        | \$1,986                 | \$12,863 | \$6,857                  | \$83,569 |

| (In thousands)               | June 30, 2012          |            |              |                  |              |                         |           |                          |             |
|------------------------------|------------------------|------------|--------------|------------------|--------------|-------------------------|-----------|--------------------------|-------------|
|                              | Commercial Real Estate |            |              |                  |              | Residential Real Estate |           |                          |             |
|                              | Commercial             | Commercial |              |                  |              | Consumer                | Mortgage  | Residential Construction | Total       |
|                              |                        | AD&C       | Investor R/E | Commercial Owner | Occupied R/E |                         |           |                          |             |
| Past due loans and leases    |                        |            |              |                  |              |                         |           |                          |             |
| 31-60 days                   | \$4,466                | \$-        | \$4,130      | \$4,223          | \$7          | \$1,015                 | \$5,841   | \$712                    | \$20,394    |
| 61-90 days                   | 341                    | -          | 247          | 456              | 4            | 80                      | 1,651     | 896                      | 3,675       |
| > 90 days                    | 70                     | 342        | -            | -                | 96           | 5                       | 91        | -                        | 604         |
| Total past due               | 5,584                  | 342        | 4,377        | 4,679            | 107          | 1,100                   | 7,583     | 1,608                    | 24,673      |
| Non-accrual loans and leases | 4,583                  | 13,055     | 13,327       | 15,146           | 872          | 1,651                   | 2,600     | 4,333                    | 55,567      |
| Current loans                | 324,580                | 138,223    | 425,533      | 559,987          | 4,639        | 354,783                 | 462,243   | 124,850                  | 2,394,838   |
| Total loans and leases       | \$334,040              | \$151,620  | \$443,237    | \$579,812        | \$5,618      | \$357,534               | \$472,426 | \$130,791                | \$2,475,078 |

| (In thousands) | December 31, 2011      |            |              |                  |              |                         |          |                          |       |
|----------------|------------------------|------------|--------------|------------------|--------------|-------------------------|----------|--------------------------|-------|
|                | Commercial Real Estate |            |              |                  |              | Residential Real Estate |          |                          |       |
|                | Commercial             | Commercial |              |                  |              | Consumer                | Mortgage | Residential Construction | Total |
|                |                        | AD&C       | Investor R/E | Commercial Owner | Occupied R/E |                         |          |                          |       |
|                |                        |            |              |                  |              |                         |          |                          |       |

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|                              |           |           |           |           |         |           |           |           |             |
|------------------------------|-----------|-----------|-----------|-----------|---------|-----------|-----------|-----------|-------------|
| Past due loans and leases    |           |           |           |           |         |           |           |           |             |
| 31-60 days                   | \$1,467   | \$717     | \$10,723  | \$1,677   | \$7     | \$467     | \$5,246   | \$1,732   | \$22,036    |
| 61-90 days                   | 62        | -         | -         | 2,537     | -       | 20        | 1,639     | -         | 4,258       |
| > 90 days                    | -         | -         | -         | -         | 2       | 165       | 167       | 243       | 577         |
| Total past due               | 1,529     | 717       | 10,723    | 4,214     | 9       | 652       | 7,052     | 1,975     | 26,871      |
| Non-accrual loans and leases | 7,226     | 18,702    | 16,963    | 14,709    | 853     | 1,786     | 5,722     | 5,719     | 71,680      |
| Current loans                | 251,572   | 141,527   | 344,262   | 503,153   | 6,092   | 357,642   | 435,888   | 101,005   | 2,141,141   |
| Total loans and leases       | \$260,327 | \$160,946 | \$371,948 | \$522,076 | \$6,954 | \$360,080 | \$448,662 | \$108,699 | \$2,239,692 |



The following tables provide information by credit risk rating indicators for each segment of the commercial loan portfolio for the dates indicated:

| June 30, 2012                      |            |           |              |                    |             |
|------------------------------------|------------|-----------|--------------|--------------------|-------------|
| Commercial Real Estate             |            |           |              |                    |             |
| (In thousands)                     | Commercial |           |              | Commercial         | Total       |
|                                    | Commercial | AD&C      | Investor R/E | Owner Occupied R/E |             |
| Risk Free to Marginally Acceptable | \$295,638  | \$132,375 | \$393,946    | \$530,032          | \$1,351,991 |
| Special Mention                    | 12,731     | 2,366     | 20,789       | 25,418             | 61,304      |
| Substandard                        | 24,325     | 16,879    | 28,502       | 23,263             | 92,969      |
| Doubtful                           | 1,346      | -         | -            | 1,099              | 2,445       |
| Total                              | \$334,040  | \$151,620 | \$443,237    | \$579,812          | \$1,508,709 |

| December 31, 2011                  |            |           |              |                    |             |
|------------------------------------|------------|-----------|--------------|--------------------|-------------|
| Commercial Real Estate             |            |           |              |                    |             |
| (In thousands)                     | Commercial |           |              | Commercial         | Total       |
|                                    | Commercial | AD&C      | Investor R/E | Owner Occupied R/E |             |
| Risk Free to Marginally Acceptable | \$225,048  | \$137,181 | \$331,095    | \$469,309          | \$1,162,633 |
| Special Mention                    | 8,551      | 2,207     | 9,592        | 22,103             | 42,453      |
| Substandard                        | 25,720     | 21,558    | 31,261       | 30,664             | 109,203     |
| Doubtful                           | 1,008      | -         | -            | -                  | 1,008       |
| Total                              | \$260,327  | \$160,946 | \$371,948    | \$522,076          | \$1,315,297 |

Homogeneous loan pools do not have individual loans subjected to internal risk ratings therefore, the credit indicator applied to these pools is based on their delinquency status. The following tables provide information by credit risk rating indicators for those remaining segments of the loan portfolio at the dates indicated:

| June 30, 2012                 |             |           |                       |           |           |
|-------------------------------|-------------|-----------|-----------------------|-----------|-----------|
| Residential Real Estate       |             |           |                       |           |           |
| (In thousands)                | Residential |           | Residential           | Total     |           |
|                               | Leasing     | Consumer  | Mortgage Construction |           |           |
| Performing                    | \$4,650     | \$355,845 | \$465,491             | \$126,458 | \$952,444 |
| Non-performing:               |             |           |                       |           |           |
| 90 days past due              | 96          | 5         | 91                    | -         | 192       |
| Non-accruing                  | 872         | 1,651     | 2,600                 | 4,333     | 9,456     |
| Restructured loans and leases | -           | 33        | 4,244                 | -         | 4,277     |
| Total                         | \$5,618     | \$357,534 | \$472,426             | \$130,791 | \$966,369 |

December 31, 2011

| (In thousands)                | Residential Real Estate |           |                      |                          | Total     |
|-------------------------------|-------------------------|-----------|----------------------|--------------------------|-----------|
|                               | Leasing                 | Consumer  | Residential Mortgage | Residential Construction |           |
| Performing                    | \$6,099                 | \$358,094 | \$439,194            | \$102,043                | \$905,430 |
| Non-performing:               |                         |           |                      |                          |           |
| 90 days past due              | 2                       | 165       | 167                  | 243                      | 577       |
| Non-accruing                  | 853                     | 1,786     | 5,722                | 5,719                    | 14,080    |
| Restructured loans and leases | -                       | 35        | 3,579                | 694                      | 4,308     |
| Total                         | \$6,954                 | \$360,080 | \$448,662            | \$108,699                | \$924,395 |

During the six months ended June 30, 2012, the Company restructured \$1.7 million in loans. Modifications consisted principally of interest rate concessions. No modifications resulted in the reduction of the recorded investment in the associated loan balances. Restructured loans are subject to periodic credit reviews to determine the necessity and adequacy of a specific loan loss allowance based on the collectability of the recorded investment in the restructured loan. Loans restructured during 2012 have specific reserves of \$0.3 million at June 30, 2012. For the year ended December 31, 2011, the Company restructured \$10.3 million in loans. Modifications consisted principally of interest rate concessions and no modifications resulted in the reduction of the recorded investment in the associated loan balances. Loans restructured during 2011 had specific reserves of \$1.9 million thousand at December 31, 2011.

The following table provides the amounts of the restructured loans at the date of restructuring for specific segments of the loan portfolio during the period indicated:

| (In thousands)                          | For the Six Months Ended June 30, 2012 |                        |                   |                                     |                       |          |
|---|--|------------------------|-------------------|-------------------------------------|-----------------------|----------|
|   | Commercial Real Estate                 |                        |                   |                                     |                       | Total    |
|   | Commercial<br>AD&C                     | Commercial<br>Investor | Commercial<br>R/E | Commercial<br>Owner<br>Occupied R/E | All<br>Other<br>Loans |          |
| Troubled debt restructurings            |  |                        |                   |                                     |                       |          |
| Restructured accruing                   | \$ 710                                 | \$ -                   | \$ -              | \$ 1,027                            | \$ -                  | \$ 1,737 |
| Restructured non-accruing               | -                                      | -                      | -                 | -                                   | -                     | -        |
| Balance                                 | \$ 710                                 | \$ -                   | \$ -              | \$ 1,027                            | \$ -                  | \$ 1,737 |
| Specific allowance                      | \$ 64                                  | \$ -                   | \$ -              | \$ 217                              | \$ -                  | \$ 281   |
| Restructured and subsequently defaulted | \$ -                                   | \$ -                   | \$ -              | \$ -                                | \$ -                  | \$ -     |

| (In thousands)                          | For the Year Ended December 31, 2011 |                        |                   |                                     |                       |           |
|---|--------------------------------------|------------------------|-------------------|-------------------------------------|-----------------------|-----------|
|   | Commercial Real Estate               |                        |                   |                                     |                       | Total     |
|   | Commercial<br>AD&C                   | Commercial<br>Investor | Commercial<br>R/E | Commercial<br>Owner<br>Occupied R/E | All<br>Other<br>Loans |           |
| Troubled debt restructurings            |                                      |                        |                   |                                     |                       |           |
| Restructured accruing                   | \$ 1,696                             | \$ -                   | \$ -              | \$ -                                | \$ 3,590              | \$ 5,286  |
| Restructured non-accruing               | 469                                  | -                      | 1,269             | 2,475                               | 763                   | 4,976     |
| Balance                                 | \$ 2,165                             | \$ -                   | \$ 1,269          | \$ 2,475                            | \$ 4,353              | \$ 10,262 |
| Specific allowance                      | \$ 254                               | \$ -                   | \$ 93             | \$ 509                              | \$ 1,027              | \$ 1,883  |
| Restructured and subsequently defaulted | \$ -                                 | \$ -                   | \$ -              | \$ -                                | \$ 509                | \$ 509    |

Changes in the accretable yield related to loans acquired with evidence of deteriorated credit quality are as follows:

| (in thousands)   | Amount |
|--|--------|
| Balance at January 1, 2012                             | \$ -   |
| CommerceFirst acquisition                              | 754    |
| Accretion recognized to date                           | (34 )  |
| Net reclassification from accretable to non-accretable | -      |
| Balance at June 30, 2012                               | \$ 720 |

Other Real Estate owned

Other real estate owned totaled \$9.6 million and \$4.4 million at June 30, 2012 and December 31, 2011. The increase compared to the prior year end was due primarily to balances added as a result of the CommerceFirst acquisition.

## Note 6 – Goodwill and Other Intangible Assets

The gross carrying amounts and accumulated amortization of intangible assets and goodwill are presented at the dates indicated in the following table:

| (Dollars in thousands)             | At June 30, 2012            |                             |                           | Weighted<br>Average<br>Remaining<br>Life | At December 31, 2011        |                             |                           | Weighted<br>Average<br>Remaining<br>Life |
|------------------------------------|-----------------------------|-----------------------------|---------------------------|--|-----------------------------|-----------------------------|---------------------------|--|
|                                    | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount |  | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount |  |
| Amortizing intangible assets:      |                             |                             |                           |  |                             |                             |                           |  |
| Core deposit intangibles           | \$9,716                     | \$ (7,270 )                 | \$ 2,446                  | 1.8<br>years                             | \$9,716                     | \$ (6,575 )                 | \$ 3,141                  | 2.3<br>years                             |
| Other identifiable intangibles     | 8,511                       | (6,940 )                    | 1,571                     | 3.0<br>years                             | 8,301                       | (6,708 )                    | 1,593                     | 3.5<br>years                             |
| Total amortizing intangible assets | \$18,227                    | \$ (14,210 )                | \$ 4,017                  |  | \$18,017                    | \$ (13,283 )                | \$ 4,734                  |  |
| Goodwill                           | \$81,892                    |                             | \$81,892                  |  | \$76,816                    |                             | \$76,816                  |  |

The following table presents the estimated future amortization expense for amortizing intangible assets within the years ending December 31:

| (In thousands)                     | Amount   |
|------------------------------------|----------|
| 2013                               | \$ 1,830 |
| 2014                               | 804      |
| 2015                               | 356      |
| 2016                               | 78       |
| Total amortizing intangible assets | \$ 3,068 |

## Note 7 – Deposits

The following table presents the composition of deposits at the dates indicated:

| (In thousands)               | June 30,<br>2012 | December 31,<br>2011 |
|------------------------------|------------------|----------------------|
| Noninterest-bearing deposits | \$763,566        | \$ 650,377           |
| Interest-bearing deposits:   |                  |                      |
| Demand                       | 383,036          | 367,682              |
| Money market savings         | 885,655          | 858,732              |

|                                      |             |              |
|--------------------------------------|-------------|--------------|
| Regular savings                      | 216,246     | 195,408      |
| Time deposits of less than \$100,000 | 361,115     | 316,058      |
| Time deposits of \$100,000 or more   | 242,437     | 268,263      |
| Total interest-bearing deposits      | 2,088,489   | 2,006,143    |
| Total deposits                       | \$2,852,055 | \$ 2,656,520 |

### **Note 8 – Stockholders’ Equity**

The Company approved a stock repurchase program in August 2011 that permits the repurchase of up to 3% of the Company’s outstanding shares of common stock or approximately 730,000 shares. Repurchases, which will be conducted through open market purchases or privately negotiated transactions, will be made depending on market conditions and other factors. The Company repurchased 23,592 shares of common stock at an average price of \$14.16 per share during the year ended December 31, 2011. No shares have been repurchased during 2012.

### **Note 9 – Share Based Compensation**

At June 30, 2012, the Company had two share based compensation plans in existence, the 1999 Stock Option Plan (expired but having outstanding options that may still be exercised) and the 2005 Omnibus Stock Plan, which is described below.

The Company's 2005 Omnibus Stock Plan ("Omnibus Plan") provides for the granting of non-qualifying stock options to the Company's directors, and incentive and non-qualifying stock options, stock appreciation rights and restricted stock grants to selected key employees on a periodic basis at the discretion of the board. The Omnibus Plan authorizes the issuance of up to 1,800,000 shares of common stock of which 958,292 are available for issuance at June 30, 2012, has a term of ten years, and is administered by a committee of at least three directors appointed by the board of directors. Options granted under the plan have an exercise price which may not be less than 100% of the fair market value of the common stock on the date of the grant and must be exercised within seven to ten years from the date of grant. The exercise price of stock options must be paid for in full in cash or shares of common stock, or a combination of both. The Stock Option Committee has the discretion when making a grant of stock options to impose restrictions on the shares to be purchased upon the exercise of such options. Options granted under the expired 1999 Stock Option Plan remain outstanding until exercised or they expire. The Company generally issues authorized but previously unissued shares to satisfy option exercises.

The fair values of all of the options granted for the periods indicated have been estimated using a binomial option-pricing model with the weighted-average assumptions for the periods shown are presented in the following table:

|  | Six Months Ended June 30, |   |         |   |
|--|---------------------------|---|---------|---|
|  | 2012                      |   | 2011    |   |
| Dividend yield                             | 2.17                      | % | 1.72    | % |
| Weighted average expected volatility       | 50.90                     | % | 46.87   | % |
| Weighted average risk-free interest rate   | 1.14                      | % | 2.58    | % |
| Weighted average expected lives (in years) | 5.35                      |   | 5.70    |   |
| Weighted average grant-date fair value     | \$ 7.85                   |   | \$ 7.76 |   |

The dividend yield is based on estimated future dividend yields. The risk-free rate for periods within the contractual term of the share option is based on the U.S. Treasury yield curve in effect at the time of the grant. Expected volatilities are generally based on historical volatilities. The expected term of share options granted is generally derived from historical experience.

Compensation expense is recognized on a straight-line basis over the vesting period of the respective stock option or restricted stock grant. The Company recognized compensation expense of \$0.3 million and \$0.3 million for the three months ended June 30, 2012 and 2011, respectively, related to the awards of stock options and restricted stock grants. Compensation expense of \$0.6 million and \$0.6 million was recognized for the six months ended June 30, 2012 and 2011, respectively. The intrinsic value for the stock options exercised in the six months ended June 30, 2012 and 2011, respectively, was not significant. The total of unrecognized compensation cost related to stock options was approximately \$0.4 million as of June 30, 2012. That cost is expected to be recognized over a weighted average period of approximately 1.9 years. The total of unrecognized compensation cost related to restricted stock was approximately \$3.6 million as of June 30, 2012. That cost is expected to be recognized over a weighted average period of approximately 3.4 years. The fair value of the options vested during the three months ended June 30, 2012 and 2011, was \$0.2 million and \$0.3 million, respectively.

In the first quarter of 2012, 20,633 stock options were granted, subject to a three year vesting schedule with one third of the options vesting each year on the anniversary date of the grant. Additionally, 83,807 shares of restricted stock were granted, subject to a five year vesting schedule with one fifth of the shares vesting each year on the grant date anniversary.



A summary of share option activity for the period indicated is reflected in the following table:

|   | Number<br>of<br>Common<br>Shares | Weighted<br>Average<br>Exercise<br>Share Price | Weighted<br>Average<br>Contractual<br>Remaining<br>Life(Years) | Aggregate<br>Intrinsic<br>Value<br>(in thousands) |
|---|----------------------------------|--|--|---|
| Balance at January 1, 2012  | 635,197                          | \$ 31.42                                       |  | \$ 406  |
| Granted   | 20,633                           | \$ 19.02                                       |  | \$ -  |
| Exercised   | (1,217 )                         | \$ 12.84                                       |  | \$ 6  |
| Forfeited or expired  | (20,700 )                        | \$ 33.63                                       |  | \$ 6  |
| Balance at June 30, 2012  | 633,913                          | \$ 30.98                                       | 2.3  | \$ 435  |
| Exercisable at June 30, 2012                                      | 578,850                          | \$ 32.21                                       | 1.9  | \$ 403  |
| Weighted average fair value of options<br>granted during the year |                                  | \$ 7.85  |  |   |

A summary of the activity for the Company's non-vested options for the period indicated is presented in the following table:

| (In dollars, except share data):      | Number<br>of Shares | Weighted<br>Average<br>Grant-Date<br>Fair Value |
|---------------------------------------|---------------------|---|
| Non-vested options at January 1, 2012 | 79,640              | \$ 6.33   |
| Granted                               | 20,633              | \$ 7.85   |
| Vested                                | (42,147 )           | \$ 5.44   |
| Forfeited or expired                  | (3,063 )            | \$ 6.69   |
| Non-vested options at June 30, 2012   | 55,063              | \$ 7.56   |

A summary of the activity for the Company's restricted stock for the period indicated is presented in the following table:

| (In dollars, except share data):    | Number<br>of<br>Shares | Weighted<br>Average<br>Grant-Date<br>Fair Value |
|-------------------------------------|------------------------|---|
| Restricted stock at January 1, 2012 | 206,313                | \$ 16.37  |
| Granted                             | 83,807                 | \$ 19.02  |
| Vested                              | (59,165 )              | \$ 16.15  |
| Forfeited or expired                | (5,494 )               | \$ 16.78  |
| Restricted stock at June 30, 2012   | 225,461                | \$ 17.40  |

**Note 10 – Pension, Profit Sharing, and Other Employee Benefit Plans**

Defined Benefit Pension Plan

The Company has a qualified, noncontributory, defined benefit pension plan (the “Plan”) covering substantially all employees. Benefits after January 1, 2005, are based on the benefit earned as of December 31, 2004, plus benefits earned in future years of service based on the employee’s compensation during each such year. All benefit accruals for employees were frozen as of December 31, 2007 based on past service and thus future salary increases and additional years of service will no longer affect the defined benefit provided by the plan although additional vesting may continue to occur.

The Company's funding policy is to contribute amounts to the plan sufficient to meet the minimum funding requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"), as amended. In addition, the Company contributes additional amounts as it deems appropriate based on benefits attributed to service prior to the date of the plan freeze. The Plan invests primarily in a diversified portfolio of managed fixed income and equity funds.

The components of net periodic benefit cost for the periods indicated are presented in the following table:

| (In thousands)                                | Three Months Ended June 30, |        | Six Months Ended June 30, |        |
|---|-----------------------------|--------|---------------------------|--------|
|   | 2012                        | 2011   | 2012                      | 2011   |
| Interest cost on projected benefit obligation | \$ 389                      | \$ 382 | \$ 777                    | \$ 768 |
| Expected return on plan assets                | (327 )                      | (269 ) | (654 )                    | (534 ) |
| Recognized net actuarial loss                 | 349                         | 276    | 699                       | 593    |
| Net periodic benefit cost                     | \$ 411                      | \$ 389 | \$ 822                    | \$ 827 |

#### Contributions

The decision as to whether or not to make a plan contribution and the amount of any such contribution is dependent on a number of factors. Such factors include the investment performance of the plan assets in the current economy and, since the plan is currently frozen, the remaining investment horizon of the plan. Given these uncertainties, management continues to monitor the funding level of the pension plan and may make contributions as necessary during 2012.

#### Note 11 – Net Income per Common Share

The calculation of net income per common share for the periods indicated is presented in the following table:

| (Dollars and amounts in thousands, except per share data) | Three Months Ended June 30, |         | Six Months Ended June 30, |          |
|---|-----------------------------|---------|---------------------------|----------|
|   | 2012                        | 2011    | 2012                      | 2011     |
| Net income  | \$7,207                     | \$8,296 | \$15,683                  | \$15,587 |
| Basic:  |                             |         |                           |          |
| Basic weighted average EPS shares                         | 24,393                      | 24,091  | 24,098                    | 24,072   |
| Basic net income per share                                | \$0.30                      | \$0.34  | \$0.65                    | \$0.65   |
| Diluted:  |                             |         |                           |          |
| Basic weighted average EPS shares                         | 24,393                      | 24,091  | 24,098                    | 24,072   |
| Dilutive common stock equivalents                         | 31                          | 39      | 83                        | 51       |

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|                              |        |        |        |        |
|------------------------------|--------|--------|--------|--------|
| Dilutive EPS shares          | 24,423 | 24,130 | 24,181 | 24,123 |
| Diluted net income per share | \$0.30 | \$0.34 | \$0.65 | \$0.65 |
| Anti-dilutive shares         | 527    | 741    | 507    | 717    |

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**NOTE 12 – OTHER COMPREHENSIVE INCOME (LOSS)**

Comprehensive income is defined as net income plus transactions and other occurrences that are the result of non-owner changes in equity. For condensed financial statements presented for the Company, non-equity changes are comprised of unrealized gains or losses on available-for-sale debt securities and any minimum pension liability adjustments. These do not have an impact on the Company's net income. The following table presents the activity in net accumulated other comprehensive income (loss) for the periods indicated:

| (In thousands)             | Unrealized Gains<br>(Losses) on<br>Investments<br>Available-for-Sale | Defined Benefit<br>Pension Plan | Total      |
|----------------------------|--|---------------------------------|------------|
| Balance at January 1, 2012 | \$ 20,006  | \$ (6,758                       | ) \$13,248 |
| Period change, net of tax  | 909  | 420                             | 1,329      |
| Balance at June 30, 2012   | \$ 20,915  | \$ (6,338                       | ) \$14,577 |

| (In thousands)             | Unrealized Gains<br>(Losses) on<br>Investments<br>Available-for-Sale | Defined Benefit<br>Pension Plan | Total       |
|----------------------------|--|---------------------------------|-------------|
| Balance at January 1, 2011 | \$ 3,764   | \$ (6,384                       | ) \$(2,620) |
| Period change, net of tax  | 7,747  | 357                             | 8,104       |
| Balance at June 30, 2011   | \$ 11,511  | \$ (6,027                       | ) \$5,484   |

**Note 13 – Financial Instruments with Off-balance Sheet Risk and Derivatives**

The Company has entered into interest rate swaps (“swaps”) to facilitate customer transactions and meet their financing needs. These swaps qualify as derivatives, but are not designated as hedging instruments. Interest rate swap contracts involve the risk of dealing with counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument contract is positive, this generally indicates that the counterparty or customer owes the Company, and results in credit risk to the Company. When the fair value of a derivative instrument contract is negative, the Company owes the customer or counterparty and therefore, has no credit risk. The notional value of commercial loan swaps outstanding was \$44.5 million with a fair value of \$1.5 million as of June 30, 2012 compared to \$54 million with a fair value of \$1.5 million as of December 31, 2011. The offsetting nature of the swaps results in a neutral effect on the Company's operations. Fair values of the swaps are carried as both gross assets and gross liabilities in the condensed consolidated statements of condition. The associated net gains and losses on the swaps are recorded in other non-interest income.

**Note 14 – Fair Value**

Generally accepted accounting principles provide entities the option to measure eligible financial assets, financial liabilities and commitments at fair value (i.e. the fair value option), on an instrument-by-instrument basis, that are

otherwise not permitted to be accounted for at fair value under other accounting standards. The election to use the fair value option is available when an entity first recognizes a financial asset or financial liability or upon entering into a commitment. Subsequent changes in fair value must be recorded in earnings. The Company applies the fair value option on residential mortgage loans held for sale. The fair value option on residential mortgage loans allows the recognition of gains on sale of mortgage loans to more accurately reflect the timing and economics of the transaction.

The standard for fair value measurement establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are described below.

**Basis of Fair Value Measurement:**

Level 1- Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2- Quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;

Level 3- Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported by little or no market activity). Changes to interest rates may result in changes in the cash flows due to prepayments or extinguishments. Accordingly, this could result in higher or lower measurements of the fair values.

A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

## **Assets and Liabilities**

### *Mortgage loans held for sale*

Mortgage loans held for sale are valued based on quotations from the secondary market for similar instruments and are classified as Level 2 of the fair value hierarchy.

### *Investments available-for-sale*

#### U.S. government agencies, mortgage-backed securities and corporate debt

Valuations are based on active market data and use of evaluated broker pricing models that vary based by asset class and includes available trade, bid, and other market information. Generally, the methodology includes broker quotes, proprietary models, descriptive terms and conditions databases coupled with extensive quality control programs. Multiple quality control evaluation processes review available market, credit and deal level information to support the evaluation of the security. If there is a lack of objectively verifiable information available to support the valuation, the evaluation of the security is discontinued. Additionally, proprietary models and pricing systems, mathematical tools, actual transacted prices, integration of market developments and experienced evaluators are used to determine the value of a security based on a hierarchy of market information regarding a security or securities with similar characteristics. The Company does not adjust the quoted price for such securities. Such instruments are generally classified within Level 2 of the fair value hierarchy.

#### State and municipal securities

Proprietary valuation matrices are used for valuing all tax-exempt municipals that can incorporate changes in the municipal market as they occur. Market evaluation models include the ability to value bank qualified municipals and general market municipals that can be broken down further according to insurer, credit support, state of issuance and

rating to incorporate additional spreads and municipal curves. Taxable municipals are valued using a third party model that incorporates a methodology that captures the trading nuances associated with these bonds. Such instruments are generally classified within Level 2 of the fair value hierarchy.

#### Trust preferred securities

In active markets, these types of instruments are valued based on quoted market prices that are readily accessible at the measurement date and are classified within Level 1 of the fair value hierarchy. Positions that are not traded in active markets or are subject to transfer restrictions are valued or adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence. In the absence of such evidence, management uses a process that employs certain assumptions to determine the present value. For further information, refer to Note 2 – Investments. Positions that are not traded in active markets or are subject to transfer restrictions are classified within Level 3 of the fair value hierarchy.

#### *Interest rate swap agreements*

Interest rate swap agreements are measured by alternative pricing sources with reasonable levels of price transparency in markets that are not active. Based on the complex nature of interest rate swap agreements, the markets these instruments trade in are not as efficient and are less liquid than that of the more mature Level 1 markets. These markets do however have comparable, observable inputs in which an alternative pricing source values these assets in order to arrive at a fair market value. These characteristics classify interest rate swap agreements as Level 2.



**Assets Measured at Fair Value on a Recurring Basis**

The following tables set forth the Company's financial assets and liabilities at the dates indicated that were accounted for or disclosed at fair value. Assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

| (In thousands)                           | At June 30, 2012   |   |                                     | Total      |
|--|--|---|-------------------------------------|------------|
|  | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Other Unobservable Inputs (Level 3) |            |
| <b>Assets</b>                            |  |   |                                     |            |
| Residential mortgage loans held for sale | \$-  | \$ 25,827                               | \$ -                                | \$25,827   |
| Investments available-for-sale:          |  |   |                                     |            |
| U.S. government agencies                 | -  | 121,620                                 | -                                   | 121,620    |
| State and municipal                      | -  | 171,706                                 | -                                   | 171,706    |
| Mortgage-backed                          | -  | 509,534                                 | -                                   | 509,534    |
| Corporate debt                           | -  | 1,995                                   | -                                   | 1,995      |
| Trust preferred                          | 1,486  | -                                       | 1,817                               | 3,303      |
| Marketable equity securities             | -  | 723                                     | -                                   | 723        |
| Interest rate swap agreements            | -  | 1,481                                   | -                                   | 1,481      |
| <b>Liabilities</b>                       |  |   |                                     |            |
| Interest rate swap agreements            | \$-  | \$ (1,481                               | ) \$ -                              | \$(1,481 ) |

| (In thousands)                           | At December 31, 2011   |   |                                     | Total      |
|--|--|---|-------------------------------------|------------|
|  | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Other Unobservable Inputs (Level 3) |            |
| <b>Assets</b>                            |  |   |                                     |            |
| Residential mortgage loans held for sale | \$-  | \$ 25,341                               | \$ -                                | \$25,341   |
| Investments available-for-sale:          |  |   |                                     |            |
| U.S. government agencies                 | -  | 200,252                                 | -                                   | 200,252    |
| State and municipal                      | -  | 173,111                                 | -                                   | 173,111    |
| Mortgage-backed                          | -  | 570,144                                 | -                                   | 570,144    |
| Corporate debt                           | -  | 1,978                                   | -                                   | 1,978      |
| Trust preferred                          | 3,249  | -                                       | 2,467                               | 5,716      |
| Marketable equity securities             | -  | 100                                     | -                                   | 100        |
| Interest rate swap agreements            | -  | 1,529                                   | -                                   | 1,529      |
| <b>Liabilities</b>                       |  |   |                                     |            |
| Interest rate swap agreements            | \$-  | \$ (1,529                               | ) \$ -                              | \$(1,529 ) |



The following table provides unrealized losses included in assets measured in the Condensed Consolidated Statements of Condition at fair value on a recurring basis for the period indicated:

| (In thousands)  | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|---|--|
| Investments available-for-sale:                                       |  |
| Balance at January 1, 2012  | \$ 2,467   |
| Total OTTI included in earnings                                       | (72 )  |
| Principal redemption  | (642 )   |
| Total unrealized losses included in other comprehensive income (loss) | 64   |
| Balance at June 30, 2012  | \$ 1,817   |

#### Assets Measured at Fair Value on a Nonrecurring Basis

The following table sets forth the Company's financial assets subject to fair value adjustments (impairment) on a nonrecurring basis at the date indicated that are valued at the lower of cost or market. Assets are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

| (In thousands)          | At June 30, 2012   | Significant<br>Unobservable<br>Inputs (Level 3)        | Total     | Total Losses |
|-------------------------|--|--|-----------|--------------|
|                         | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identifiable<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs (Level 2) |           |              |
| Impaired loans          | \$-  | \$ -   | \$ 52,691 | \$ (5,138 )  |
| Other real estate owned | -  | -  | 9,553     | (592 )       |
| Total                   | \$-  | \$ -   | \$ 62,244 | \$ (5,730 )  |

| (In thousands) | At December 31, 2011                               | Significant<br>Unobservable<br>Inputs (Level 3)        | Total | Total Losses |
|----------------|--|--|-------|--------------|
|                | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for | Significant<br>Other<br>Observable<br>Inputs (Level 2) |       |              |

|                         |           |    |   |           |          |             |
|-------------------------|-----------|----|---|-----------|----------|-------------|
|                         | Identical |    |   |           |          |             |
|                         | Assets    |    |   |           |          |             |
|                         | (Level    |    |   |           |          |             |
|                         | 1)        |    |   |           |          |             |
| Impaired loans          | \$-       | \$ | - | \$ 59,784 | \$59,784 | \$ (5,565 ) |
| Other real estate owned | -         | -  | - | 4,431     | 4,431    | (786 )      |
| Total                   | \$-       | \$ | - | \$ 64,215 | \$64,215 | \$ (6,351 ) |

At June 30, 2012, impaired loans totaling \$57.6 million were written down to fair value of \$52.7 million as a result of specific loan loss allowances of \$4.9 million associated with the impaired loans which was included in the allowance for loan losses. Impaired loans totaling \$67.6 million were written down to fair value of \$59.8 million at December 31, 2011 as a result of specific loan loss allowances of \$7.8 million associated with the impaired loans.

Loan impairment is measured using the present value of expected cash flows, the loan's observable market price or the fair value of the collateral (less selling costs) if the loans are collateral dependent and are classified at a Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable. The value of business equipment, inventory and accounts receivable collateral is based on net book value on the business' financial statements and, if necessary, discounted based on management's review and analysis. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the factors identified above. Valuation techniques are consistent with those techniques applied in prior periods.

Other real estate owned (“OREO”) is adjusted to fair value upon transfer of the loans to OREO. Subsequently, OREO is carried at the lower of carrying value or fair value. The estimated fair value for other real estate owned included in Level 3 is determined by independent market based appraisals and other available market information, less cost to sell, that may be reduced further based on market expectations or an executed sales agreement. If the fair value of the collateral deteriorates subsequent to initial recognition, the Company records the OREO as a non-recurring Level 3 adjustment. Valuation techniques are consistent with those techniques applied in prior periods.

#### Fair Value of Financial Instruments

The Company discloses fair value information about financial instruments for which it is practicable to estimate the value, whether or not such financial instruments are recognized on the balance sheet. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation, and is best evidenced by a quoted market price, if one exists.

Quoted market prices, where available, are shown as estimates of fair market values. Because no quoted market prices are available for a significant portion of the Company's financial instruments, the fair value of such instruments has been derived based on the amount and timing of future cash flows and estimated discount rates.

Present value techniques used in estimating the fair value of many of the Company's financial instruments are significantly affected by the assumptions used. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate cash settlement of the instrument. Additionally, the accompanying estimates of fair values are only representative of the fair values of the individual financial assets and liabilities, and should not be considered an indication of the fair value of the Company.

The carrying amounts and fair values of the Company's financial instruments at the dates indicated are presented in the following table:

|  | June 30, 2012   |            | Fair Value Measurements   |   |   |
|--|-----------------|------------|---|---|---|
|  | Carrying Amount | Fair Value | Quoted Prices in Active Markets for Identifiable Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Financial Assets</b>  |                 |            |   |   |   |
| Investments held-to-maturity and other equity securities                       | \$ 197,862      | \$ 202,412 | \$-   | \$ 202,412                                    | \$ -                                      |
| Loans, net of allowance  | 2,429,813       | 2,506,993  | -   | -   | 2,506,993                                 |
| Other assets   | 82,392          | 82,392     | -   | 82,392  | -   |
| <b>Financial Liabilities</b>   |                 |            |   |   |   |
| Time Deposits  | \$ 603,552      | \$ 606,810 | \$-   | \$ 606,810                                    | \$ -                                      |
| Securities sold under retail repurchase agreements and federal funds purchased | 64,779          | 64,779     | -   | 64,779  | -   |
| Advances from FHLB   | 405,233         | 452,562    | -   | 452,562                                       | -   |
| Subordinated debentures  | 35,000          | 9,713      | -   | -   | 9,713                                     |

|  | December 31, 2011 |            | Fair Value Measurements   |   |   |
|--|-------------------|------------|---|---|---|
|  | Carrying Amount   | Fair Value | Quoted Prices in Active Markets for Identifiable Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Financial Assets</b>                                  |                   |            |   |   |   |
| Investments held-to-maturity and other equity securities | \$ 213,398        | \$ 219,100 | \$-   | \$ 219,100                                    | \$ -                                      |
| Loans, net of allowance                                  | 2,190,266         | 2,276,333  | -   | -   | 2,276,333                                 |
| Other assets   | 81,098            | 81,098     | -   | 81,098  | -   |
| <b>Financial Liabilities</b>                             |                   |            |   |   |   |

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|  |           |           |     |            |       |
|--|-----------|-----------|-----|------------|-------|
| Time Deposits  | \$584,321 | \$588,818 | \$- | \$ 588,818 | \$ -  |
| Securities sold under retail repurchase agreements and federal funds purchased | 143,613   | 143,613   | -   | 143,613    | -     |
| Advances from FHLB   | 405,408   | 452,378   | -   | 452,378    | -     |
| Subordinated debentures  | 35,000    | 9,810     | -   | -          | 9,810 |

The following methods and assumptions were used to estimate the fair value of each category of financial instruments for which it is practicable to estimate that value:

**Cash and Temporary Investments:** The carrying amounts of cash and cash equivalents approximate their fair value and have been excluded from the table above.

**Investments:** The fair value of marketable securities is based on quoted market prices, prices quoted for similar instruments, and prices obtained from independent pricing services.

**Loans:** For certain categories of loans, such as mortgage, installment and commercial loans, the fair value is estimated by discounting the expected future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and similar remaining maturities. Expected cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

**Accrued interest receivable:** The carrying value of accrued interest receivable approximates fair value due to the short-term duration and has been excluded from the table above.

**Other assets:** The investment in bank-owned life insurance represents the cash surrender value of the policies at June 30, 2012 and December 31, 2011 as determined by the each insurance carrier. The carrying value of accrued interest receivable approximates fair values due to the short-term duration.

**Deposits:** The fair value of demand, money market savings and regular savings deposits, which have no stated maturity, were considered equal to their carrying amount, representing the amount payable on demand. While management believes that the Bank's core deposit relationships provide a relatively stable, low-cost funding source that has a substantial intangible value separate from the value of the deposit balances, these estimated fair values do not include the intangible value of core deposit relationships, which comprise a significant portion of the Bank's deposit base.

**Short-term borrowings:** The carrying values of short-term borrowings, including overnight, securities sold under agreements to repurchase and federal funds purchased approximates the fair values due to the short maturities of those instruments.

**Long-term borrowings:** The fair value of the Federal Home Loan Bank of Atlanta advances and subordinated debentures was estimated by computing the discounted value of contractual cash flows payable at current interest rates for obligations with similar remaining terms. The Company's credit risk is not material to calculation of fair value because these borrowings are collateralized. The Company classifies advances from the Federal Home Loan Bank of Atlanta within Level 2 of the fair value hierarchy since the fair value of such borrowings is based on rates currently available for borrowings with similar terms and remaining maturities. Subordinated debentures are classified as Level 3 in the fair value hierarchy due to the lack of market activity of such instruments.

**Accrued interest payable:** The carrying value of accrued interest payable approximates fair value due to the short-term duration and has been excluded from the table above.

## **Note 15 - Segment Reporting**

Currently, the Company conducts business in three operating segments—Community Banking, Insurance and Investment Management. Each of the operating segments is a strategic business unit that offers different products and services. The Insurance and Investment Management segments were businesses that were acquired in separate transactions where management of acquisition was retained. The accounting policies of the segments are the same as those of the Company. However, the segment data reflect inter-segment transactions and balances.

The Community Banking segment is conducted through Sandy Spring Bank and involves delivering a broad range of financial products and services, including various loan and deposit products to both individuals and businesses. Parent



company income is included in the Community Banking segment, as the majority of effort of these functions is related to this segment. Major revenue sources include net interest income, gains on sales of mortgage loans, trust income, fees on sales of investment products and service charges on deposit accounts. Expenses include personnel, occupancy, marketing, equipment and other expenses. Non-cash charges associated with amortization of intangibles related to the acquired entities amounted to \$0.4 million and \$0.4 million in for the three months ended June 30, 2012 and 2011, respectively. For the six months ended June 30, 2012 and 2011, these non-cash charges amounted to \$0.7 million and \$0.7 million, respectively.

The Insurance segment is conducted through Sandy Spring Insurance Corporation, a subsidiary of the Bank, and offers annuities as an alternative to traditional deposit accounts. Sandy Spring Insurance Corporation operates Sandy Spring Insurance, a general insurance agency located in Annapolis, Maryland, and Neff and Associates, located in Ocean City, Maryland. Major sources of revenue are insurance commissions from commercial lines, personal lines, and medical liability lines. Expenses include personnel and support charges. Non-cash charges associated with amortization of intangibles related to the acquired entities was not significant for the three and six months ended June 30, 2012 and 2011, respectively.

The Investment Management segment is conducted through West Financial Services, Inc., a subsidiary of the Bank. This asset management and financial planning firm, located in McLean, Virginia, provides comprehensive investment management and financial planning to individuals, families, small businesses and associations including cash flow analysis, investment review, tax planning, retirement planning, insurance analysis and estate planning. West Financial currently has approximately \$808 million in assets under management. Major revenue sources include non-interest income earned on the above services. Expenses include personnel and support charges. Non-cash charges associated with amortization of intangibles related to the acquired entities was not significant for the three and six months ended June 30, 2012 and 2011, respectively. .

Information for the operating segments and reconciliation of the information to the consolidated financial statements for the periods indicated is presented in the following tables:

| (In thousands)                      | Three Months Ended June 30, 2012 |           |            |               |               |
|-------------------------------------|----------------------------------|-----------|------------|---------------|---------------|
|                                     | Community                        |           | Investment | Inter-Segment | Total         |
|                                     | Banking                          | Insurance | Mgmt.      | Elimination   |               |
| Interest income                     | \$35,558                         | \$ 2      | \$ 2       | \$ (4         | ) \$35,558    |
| Interest expense                    | 5,753                            | -         | -          | (4            | ) 5,749       |
| Provision for loan and lease losses | 1,585                            | -         | -          | -             | 1,585         |
| Noninterest income                  | 9,306                            | 1,026     | 1,364      | (203          | ) 11,493      |
| Noninterest expenses                | 27,365                           | 954       | 742        | (203          | ) 28,858      |
| Income before income taxes          | 10,161                           | 74        | 624        | -             | 10,859        |
| Income tax expense                  | 3,379                            | 30        | 243        | -             | 3,652         |
| Net income                          | \$6,782                          | \$44      | \$ 381     | \$ -          | \$7,207       |
| Assets                              | \$3,870,262                      | \$ 13,180 | \$ 15,537  | \$ (43,802    | ) \$3,855,177 |

| (In thousands)                      | Three Months Ended June 30, 2011 |           |            |               |               |
|-------------------------------------|----------------------------------|-----------|------------|---------------|---------------|
|                                     | Community                        |           | Investment | Inter-Segment | Total         |
|                                     | Banking                          | Insurance | Mgmt.      | Elimination   |               |
| Interest income                     | \$35,025                         | \$ 2      | \$ 2       | \$ (21        | ) \$35,008    |
| Interest expense                    | 6,875                            | -         | -          | (21           | ) 6,854       |
| Provision for loan and lease losses | 1,151                            | -         | -          | -             | 1,151         |
| Noninterest income                  | 8,520                            | 1,099     | 1,385      | (202          | ) 10,802      |
| Noninterest expenses                | 24,086                           | 1,141     | 813        | (202          | ) 25,838      |
| Income before income taxes          | 11,433                           | (40       | ) 574      | -             | 11,967        |
| Income tax expense                  | 3,463                            | (16       | ) 224      | -             | 3,671         |
| Net income                          | \$7,970                          | \$(24     | ) \$ 350   | \$ -          | \$8,296       |
| Assets                              | \$3,642,323                      | \$ 12,708 | \$ 14,092  | \$ (57,107    | ) \$3,612,016 |

| (In thousands)                      | Six Months Ended June 30, 2012 |           |            |               |               |
|-------------------------------------|--------------------------------|-----------|------------|---------------|---------------|
|                                     | Community                      |           | Investment | Inter-Segment | Total         |
|                                     | Banking                        | Insurance | Mgmt.      | Elimination   |               |
| Interest income                     | \$70,173                       | \$ 3      | \$ 5       | \$ (8         | ) \$70,173    |
| Interest expense                    | 11,667                         | -         | -          | (8            | ) 11,659      |
| Provision for loan and lease losses | 2,249                          | -         | -          | -             | 2,249         |
| Noninterest income                  | 17,800                         | 2,312     | 2,761      | (406          | ) 22,467      |
| Noninterest expenses                | 52,232                         | 2,168     | 1,547      | (406          | ) 55,541      |
| Income before income taxes          | 21,825                         | 147       | 1,219      | -             | 23,191        |
| Income tax expense                  | 6,973                          | 60        | 475        | -             | 7,508         |
| Net income                          | \$14,852                       | \$ 87     | \$ 744     | \$ -          | \$15,683      |
| Assets                              | \$3,870,262                    | \$ 13,180 | \$ 15,537  | \$ (43,802    | ) \$3,855,177 |

| (In thousands)                      | Six Months Ended June 30, 2011 |           |                     |                              |               |
|-------------------------------------|--------------------------------|-----------|---------------------|------------------------------|---------------|
|                                     | Community<br>Banking           | Insurance | Investment<br>Mgmt. | Inter-Segment<br>Elimination | Total         |
| Interest income                     | \$69,814                       | \$ 3      | \$ 4                | \$ (63                       | ) \$69,758    |
| Interest expense                    | 13,657                         | -         | -                   | (63                          | ) 13,594      |
| Provision for loan and lease losses | 2,666                          | -         | -                   | -                            | 2,666         |
| Noninterest income                  | 16,078                         | 2,390     | 2,731               | (405                         | ) 20,794      |
| Noninterest expenses                | 48,433                         | 2,292     | 1,580               | (405                         | ) 51,900      |
| Income before income taxes          | 21,136                         | 101       | 1,155               | -                            | 22,392        |
| Income tax expense                  | 6,314                          | 41        | 450                 | -                            | 6,805         |
| Net income                          | \$14,822                       | \$ 60     | \$ 705              | \$ -                         | \$ 15,587     |
| Assets                              | \$3,642,323                    | \$ 12,708 | \$ 14,092           | \$ (57,107                   | ) \$3,612,016 |

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

### The Company

Sandy Spring Bancorp, Inc. (the "Company") is the bank holding company for Sandy Spring Bank (the "Bank"). The Company is registered as a bank holding company pursuant to the Bank Holding Company Act of 1956, as amended (the "Holding Company Act"). As such, the Company is subject to supervision and regulation by the Board of Governors of the Federal Reserve System (the "Federal Reserve"). The Company began operating in 1988. The Bank was founded in 1868 and is the oldest banking business based in Maryland. The Bank is independent, community oriented, and conducts a full-service commercial banking business through 49 community offices located in Anne Arundel, Carroll, Frederick, Howard, Montgomery and Prince George's counties in Maryland, and Arlington, Fairfax and Loudoun counties in Virginia. The Bank is a state chartered bank subject to supervision and regulation by the Federal Reserve and the State of Maryland. The Bank's deposit accounts are insured by the Deposit Insurance Fund administered by the Federal Deposit Insurance Corporation (the "FDIC") to the maximum permitted by law. The Bank is a member of the Federal Reserve System and is an Equal Housing Lender. The Company, the Bank, and its other subsidiaries are Affirmative Action/Equal Opportunity Employers.

### Overview

Net income for the Company for the second quarter of 2012 totaled \$7.2 million (\$0.30 per diluted share), compared to net income of \$8.3 million (\$0.34 per diluted share) for the second quarter of 2011. For the first six months of 2012, net income totaled \$15.7 million (\$0.65 per diluted share) compared to net income of \$15.6 million (\$0.65 per diluted share) for the prior year period. These results reflect the following events:

During the second quarter of 2012 the Company completed the acquisition of CommerceFirst Bancorp, Inc. ("CommerceFirst") and its wholly-owned subsidiary, CommerceFirst Bank. Under the terms of the acquisition the Company acquired 100% of the outstanding shares of CommerceFirst common stock for a combination of 50% Company stock and 50% cash. The transaction has been accounted for using the acquisition method of accounting. Assets acquired amounted to \$190.9 million, including loans and leases of \$169.0 million. Liabilities assumed totaled \$170.6 million, including \$169.9 million in deposits. The acquisition resulted in the addition of \$13.0 million to the Company's equity. Consolidated results of operations for CommerceFirst are included subsequent to the close of business on May 31, 2012 and include \$2.6 million in merger costs.

Average total loans for the second quarter of 2012 increased 10% compared to the second quarter of 2011 due largely to organic growth in commercial loans and the acquisition of CommerceFirst.

Net interest income increased 6% for the second quarter of 2012 compared to the second quarter of 2011. For the year-to-date, net interest income increased 4% for 2012 compared to the first six months of 2011. These increases were due primarily to growth in average interest-earning assets combined with an increase in noninterest-bearing deposits, which together more than offset lower earning asset yields in the current low interest rate environment. The provision for loan and lease losses was \$1.6 million for the second quarter of 2012 compared to \$1.2 million for the second quarter of 2011 and \$0.7 million for the first quarter of 2012. The increase in the provision for the second quarter of 2012 compared to both the prior quarter and the second quarter of 2011 was due primarily to an increase in specific reserves on non-performing loans.

Noninterest income increased \$0.7 million or 6% for the second quarter of 2012 compared to the second quarter of 2011 due largely to growth in income from mortgage banking activities due to an increased volume of refinancing activity.

In the second quarter of 2012, the nation and the mid-Atlantic region in which the Company operates continued to show a mix of both positive and negative economic signs in a number of metrics. Concerns over a struggling national economy and possible federal government spending cuts and tax increases at year-end continued to impede both the regional and national economic outlook in many respects. While the housing markets have shown improvement compared to the prior year, sales of existing homes continue to be limited by a lack of inventory of existing homes due to current price levels. Volatility continued as positive trends in housing and energy prices have been offset by uncertainty on the part of both large and small businesses which has limited economic expansion on both a regional and national basis. The financial stability of banks in Western Europe and the European Union itself continues to be an underlying volatility factor. Although unemployment rates continue to be strong on a regional basis, they have leveled off nationally and remain at historically high levels. Together with municipal budget deficits across the country, these factors have caused enough economic uncertainty, particularly among individual consumers and small and medium-sized businesses, to suppress confidence and thus constrain the pace of economic recovery and expansion. Despite this challenging business environment, the Company has emphasized the fundamentals of community banking as it has maintained strong levels of liquidity and capital and overall credit quality has continued to improve.

The net interest margin was 3.62% for the second quarter of 2012 compared to 3.58% for the second quarter of 2011 and 3.56% for the first quarter of 2012. During the second quarter of 2012, the growth in average interest-earning assets and noninterest-bearing deposits largely offset a decline in the average rates earned on interest-earning assets. The margin increase compared to the prior quarter was driven primarily by higher levels of interest-earning assets, primarily from the addition of higher yielding loans from the CommerceFirst transaction, and a higher level of noninterest-bearing deposits, which offset the decline in the average rates earned on interest-earning assets. Average total deposits increased 4% for the quarter compared with the prior year period, while average loans increased 10% compared to 2011, due to the economic factors mentioned above.

Liquidity remained strong due to the borrowing lines with the Federal Home Loan Bank of Atlanta and the Federal Reserve and the size and composition of the investment portfolio.

The Company's credit quality continued to improve as non-performing assets decreased to \$74.0 million at June 30, 2012 from \$83.4 million at June 30, 2011 and \$77.0 million at March 31, 2012. This decrease was due primarily to a combination of the Company's continuing efforts at resolution of non-performing loans and reduced migration of existing loans into nonperforming status, particularly in the commercial real estate portfolio. Non-performing assets represented 1.92% of total assets at June 30, 2012 compared to 2.31% at June 30, 2011. The ratio of net charge-offs to average loans and leases was .23% for the second quarter of 2012, compared to .90% for the second quarter of 2011.

At June 30, 2012, the Bank remained above all "well-capitalized" regulatory requirement levels. In addition, tangible book value per common share increased 7% to \$14.91 from \$13.93 at June 30, 2011.

Total assets at June 30, 2012 increased 4% compared to December 31, 2011. Loan balances increased 11% compared to the prior year end due primarily to increases of 8% in residential mortgage and construction loans and 15% in commercial loans which were somewhat offset by a 1% decrease in consumer loans. The increase in commercial loans was primarily due to the CommerceFirst acquisition during the quarter. Customer funding sources, which include deposits plus other short-term borrowings from core customers, increased 7% compared to balances at December 31, 2011, again due largely to the CommerceFirst acquisition. Deposits acquired in the CommerceFirst acquisition caused increases in several deposit categories. Certificates of deposit increased 3% compared to balances at December 31, 2011, while regular savings grew 11%, interest-bearing checking accounts increased 4%, noninterest-bearing deposits increased 17% and money market accounts increased 3%. The Company continued to manage its net interest margin, primarily by reducing rates on certificates of deposit to preserve the net interest margin during this extended period of historically low interest rates. During the same period, stockholders' equity increased to \$471.5 million due to stock issued in connection with the CommerceFirst acquisition and net income in the first six months of 2012.

Net interest income increased by \$1.7 million, or 6% for the quarter ended June 30, 2012 compared to the prior year period. The effects of an 18 basis point decrease in the cost of interest-bearing liabilities, growth of 15% in average noninterest-bearing deposits, 4% growth in average interest-earning assets and an 8% decrease in non-performing

assets more than offset a decline of 13 basis points in the yield on average interest-earning assets.

Non-interest income increased 6% for the second quarter of 2012 compared to 2011. Income from mortgage banking activities increased 59% due to a higher volume of mortgage refinancing activity in the second quarter of 2012 compared to the second quarter of 2011. In addition other noninterest income increased 26% over the prior year quarter due to higher fees from loan prepayments and other fees. These increases were somewhat offset by a decrease of 6% in service charges on deposits due to lower overdraft fees.

Non-interest expenses increased 12% in the second quarter of 2012 compared to the prior year period due primarily to \$2.2 million of merger expenses recognized during the quarter. This increase was driven by higher salaries and benefits expenses, outside data services costs and professional fees primarily resulting from the CommerceFirst acquisition. These increases were somewhat offset by an 11% decrease in FDIC insurance expense due to a regulatory change in the calculation of such premiums that was effective with the second quarter of 2011.

## Critical Accounting Policies

The Company's condensed consolidated financial statements are prepared in accordance with generally accepted accounting principles ("GAAP") in the United States of America and follow general practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements may reflect different estimates, assumptions, and judgments. Certain policies inherently rely to a greater extent on the use of estimates, assumptions, and judgments and as such may have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary for assets and liabilities that are required to be recorded at fair value. A decline in the value of assets required to be recorded at fair value will warrant an impairment write-down or valuation allowance to be established. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when readily available. The following accounting policies comprise those policies that management believes are the most critical to aid in fully understanding and evaluating our reported financial results:

- Allowance for loan and lease losses;
- Goodwill impairment;
- Accounting for income taxes;
- Fair value measurements, including assessment of other than temporary impairment;
- Defined benefit pension plan.

### *Allowance for Loan and Lease Losses*

The allowance for loan and lease losses is an estimate of the losses that are inherent in the loan and lease portfolio at the balance sheet date. The allowance is based on the basic principle that a loss be accrued when it is probable that the loss has occurred at the date of the financial statements and the amount of the loss can be reasonably estimated.

Management believes that the allowance is adequate. However, its determination requires significant judgment, and estimates of probable losses in the lending portfolio can vary significantly from the amounts actually observed. While management uses available information to recognize probable losses, future additions or reductions to the allowance may be necessary based on changes in the loans and leases comprising the portfolio and changes in the financial condition of borrowers, resulting from changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, and independent consultants engaged by the Company periodically review the loan and lease portfolio and the allowance. Such reviews may result in additional provisions based on their judgments of information available at the time of each examination.

The Company's allowance for loan and lease losses has two basic components: a general allowance reflecting historical losses by loan category, as adjusted by several factors whose effects are not reflected in historical loss ratios,



and specific allowances for individually identified loans. Each of these components, and the allowance methodology used to establish them, are described in detail in Note 1 of the Notes to the Condensed Consolidated Financial Statements included in this report. The amount of the allowance is reviewed monthly by the Credit and Investment Risk Committee of the board of directors and formally approved quarterly by that same committee of the board.

General allowances are based upon historical loss experience by portfolio segment measured over the prior eight quarters and weighted so that losses realized in the most recent quarters have the greatest effect. The historical loss experience is supplemented to address various risk characteristics of the Company's loan portfolio including:

- trends in delinquencies and other non-performing loans;
- changes in the risk profile related to large loans in the portfolio;
- changes in the categories of loans comprising the loan portfolio;
- concentrations of loans to specific industry segments;
- changes in economic conditions on both a local and national level;
- changes in the Company's credit administration and loan portfolio management processes; and
- quality of the Company's credit risk identification processes.

The general allowance comprised 89% of the total allowance at June 30, 2012 and 84% at December 31, 2011. The general allowance is calculated in two parts based on an internal risk classification of loans within each portfolio segment. Allowances on loans considered to be “criticized” and “classified” under regulatory guidance are calculated separately from loans considered to be “pass” rated under the same guidance. This segregation allows the Company to monitor the allowance applicable to higher risk loans separate from the remainder of the portfolio in order to better manage risk and ensure the sufficiency of the allowance for loan and lease losses.

The portion of the allowance representing specific allowances is established on individually impaired loans. As a practical expedient, for collateral dependent loans, the Company measures impairment based on the net realizable value of the underlying collateral. For loans on which the Company has not elected to use a practical expedient to measure impairment, the Company will measure impairment based on the present value of expected future cash flows discounted at the loan’s effective interest rate. In determining the cash flows to be included in the discount calculation the Company considers the following factors that combine to estimate the probability and severity of potential losses:

- the borrower’s overall financial condition;
- resources and payment record;
- demonstrated or documented support available from financial guarantors; and
- the adequacy of collateral value and the ultimate realization of that value at liquidation.

These factors combine to estimate the probability and severity of potential losses. At June 30, 2012, the specific allowance accounted for 11% of the total allowance as compared to 16% at December 31, 2011. The severity of estimated losses on impaired loans can differ substantially from actual losses.

#### *Goodwill and Other Intangible Asset Impairment*

Goodwill represents the excess purchase price paid over the fair value of the net assets acquired in a business combination. Goodwill is not amortized but is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. Impairment testing requires that the fair value of each of the Company’s reporting units be compared to the carrying amount of the reporting unit’s net assets, including goodwill. The Company’s reporting units were identified based upon an analysis of each of its individual operating segments. If the fair values of the reporting units exceed their book values, no write-down of recorded goodwill is required. If the fair value of a reporting unit is less than book value, an expense may be required to write-down the related goodwill to the proper carrying value. The Company tests for impairment of goodwill as of October 1 of each year using September 30 data and again at any quarter-end if any triggering events occur during a quarter that may affect goodwill. Examples of such events include, but are not limited to, a significant deterioration in future operating results, adverse action by a regulator or a loss of key personnel. Determining the fair value of a reporting unit requires the Company to use a degree of subjectivity.

Recently amended accounting guidance provides the Company with the option to assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. Based on the assessment of these qualitative factors,

if it is determined that the fair value of a reporting unit is not less than the carrying value, then performing the two-step impairment process, previously required, is unnecessary. However, if it is determined that the carrying value exceeds the fair value the second step, described above, of the two-step process must be performed. This guidance was effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, with early adoption permitted. The Company elected to adopt this guidance early in the fourth quarter of 2011. At June 30, 2012 there was no evidence of impairment of goodwill or intangibles in any of the Company's reporting units.

Other intangible assets represent purchased assets that lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset, or liability. Other intangible assets have finite lives and are reviewed for impairment annually. These assets are amortized over their estimated useful lives on a straight-line basis over varying periods that initially did not exceed 15 years.

### *Accounting for Income Taxes*

The Company accounts for income taxes by recording deferred income taxes that reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Management exercises significant judgment in the evaluation of the amount and timing of the recognition of the resulting tax assets and liabilities. The judgments and estimates required for the evaluation are updated based upon changes in business factors and the tax laws. If actual results differ from the assumptions and other considerations used in estimating the amount and timing of tax recognized, there can be no assurance that additional expenses will not be required in future periods. The Company's accounting policy follows the prescribed authoritative guidance that a minimal probability threshold of a tax position must be met before a financial statement benefit is recognized. The Company recognized, when applicable, interest and penalties related to unrecognized tax benefits in other non-interest expenses in the Condensed Consolidated Statements of Income. Assessment of uncertain tax positions requires careful consideration of the technical merits of a position based on management's analysis of tax regulations and interpretations. Significant judgment may be involved in applying the applicable reporting and accounting requirements.

Management expects that the Company's adherence to the required accounting guidance may result in increased volatility in quarterly and annual effective income tax rates due to the requirement that any change in judgment or measurement of a tax position taken in a prior period be recognized as a discrete event in the period in which it occurs. Factors that could impact management's judgment include changes in income, tax laws and regulations, and tax planning strategies.

### *Fair Value Measurements*

The Company measures certain financial assets and liabilities at fair value in accordance with applicable accounting standards. Significant financial instruments measured at fair value on a recurring basis are investment securities available-for-sale, residential mortgages held for sale and commercial loan interest rate swap agreements. Loans where it is probable that the Company will not collect all principal and interest payments according to the contractual terms are considered impaired loans and are measured on a nonrecurring basis.

The Company conducts a quarterly review for all investment securities that have potential impairment to determine whether unrealized losses are other-than-temporary. Valuations for the investment portfolio are determined using quoted market prices, where available. If quoted market prices are not available, valuations are based on pricing models, quotes for similar investment securities, and, where necessary, an income valuation approach based on the present value of expected cash flows. In addition, the Company considers the financial condition of the issuer, the receipt of principal and interest according to the contractual terms and the intent and ability of the Company to hold the investment for a period of time sufficient to allow for any anticipated recovery in fair value.

The above accounting policies with respect to fair value are discussed in further detail in "Note 14-Fair Value" to the Condensed Consolidated Financial Statements.

*Defined Benefit Pension Plan*

The Company has a qualified, noncontributory, defined benefit pension plan. The plan was frozen for existing entrants after December 31, 2007 and all benefit accruals for employees were frozen as of December 31, 2007 based on past service. Future salary increases and additional years of service will no longer affect the defined benefit provided by the plan although additional vesting may continue to occur.

Several factors affect the net periodic benefit cost of the plan, including (1) the size and characteristics of the plan population, (2) the discount rate, (3) the expected long-term rate of return on plan assets and (4) other actuarial assumptions. Pension cost is directly related to the number of employees covered by the plan and other factors including salary, age, years of employment, and the terms of the plan. As a result of the plan freeze, the characteristics of the plan population should not have a materially different effect in future years. The discount rate is used to determine the present value of future benefit obligations. The discount rate is determined by matching the expected cash flows of the plan to a yield curve based on long term, high quality fixed income debt instruments available as of the measurement date, which is December 31 of each year. The discount rate is adjusted each year on the measurement date to reflect current market conditions. The expected long-term rate of return on plan assets is based on a number of factors that include expectations of market performance and the target asset allocation adopted in the plan investment policy. Should actual asset returns deviate from the projected returns, this can affect the benefit plan expense recognized in the financial statements.

**Consolidated Average Balances, Yields and Rates**

| (Dollars in thousands and tax-equivalent)      | Six Months Ended June 30,<br>2012 |                 |                                     | 2011                |                 |                                     |   |
|--|-----------------------------------|-----------------|-------------------------------------|---------------------|-----------------|-------------------------------------|---|
|  | Average<br>Balances               | (1)<br>Interest | Annualized<br>Average<br>Yield/Rate | Average<br>Balances | (1)<br>Interest | Annualized<br>Average<br>Yield/Rate |   |
| <b>Assets</b>                                  |                                   |                 |                                     |                     |                 |                                     |   |
| Residential mortgage loans (2)                 | \$481,396                         | \$10,741        | 4.49                                | % \$457,059         | \$11,374        | 4.97                                | % |
| Residential construction loans                 | 121,106                           | 2,291           | 3.80                                | 85,013              | 1,549           | 3.68                                |   |
| Commercial ADC loans                           | 155,571                           | 3,890           | 5.03                                | 149,424             | 3,125           | 4.22                                |   |
| Commercial investor real estate loans          | 393,665                           | 10,764          | 5.50                                | 346,410             | 10,328          | 5.98                                |   |
| Commercial owner occupied real estate<br>loans | 529,176                           | 14,784          | 5.68                                | 505,060             | 14,926          | 5.99                                |   |
| Commercial business loans                      | 271,185                           | 6,816           | 4.93                                | 231,267             | 5,648           | 4.93                                |   |
| Leasing  | 5,927                             | 193             | 6.53                                | 12,574              | 419             | 6.66                                |   |
| Consumer loans                                 | 358,896                           | 6,327           | 3.57                                | 364,665             | 6,683           | 3.72                                |   |
| Total loans and leases (3)                     | 2,316,922                         | 55,806          | 4.85                                | 2,151,472           | 54,052          | 5.06                                |   |
| Taxable securities                             | 791,303                           | 10,253          | 2.59                                | 860,042             | 11,766          | 2.74                                |   |
| Tax-exempt securities (4)                      | 278,095                           | 6,784           | 4.88                                | 228,175             | 6,634           | 5.81                                |   |
| Interest-bearing deposits with banks           | 34,410                            | 45              | 0.26                                | 30,359              | 39              | 0.26                                |   |
| Federal funds sold                             | 985                               | 1               | 0.16                                | 1,447               | 1               | 0.15                                |   |
| Total interest-earning assets                  | 3,421,715                         | 72,889          | 4.27                                | 3,271,495           | 72,492          | 4.45                                |   |
| Less: allowance for loan and lease losses      | (48,439 )                         |                 |                                     | (60,040 )           |                 |                                     |   |
| Cash and due from banks                        | 45,470                            |                 |                                     | 44,654              |                 |                                     |   |
| Premises and equipment, net                    | 48,820                            |                 |                                     | 49,178              |                 |                                     |   |
| Other assets                                   | 205,582                           |                 |                                     | 228,437             |                 |                                     |   |
| Total assets                                   | \$3,673,148                       |                 |                                     | \$3,533,724         |                 |                                     |   |
| <b>Liabilities and Stockholders' Equity</b>    |                                   |                 |                                     |                     |                 |                                     |   |
| Interest-bearing demand deposits               | \$373,740                         | 171             | 0.09                                | % \$330,470         | 176             | 0.11                                | % |
| Regular savings deposits                       | 206,721                           | 104             | 0.10                                | 180,067             | 95              | 0.11                                |   |
| Money market savings deposits                  | 857,020                           | 983             | 0.23                                | 850,359             | 1,956           | 0.46                                |   |
| Time deposits                                  | 570,768                           | 2,626           | 0.93                                | 622,420             | 3,673           | 1.19                                |   |
| Total interest-bearing deposits                | 2,008,250                         | 3,884           | 0.39                                | 1,983,316           | 5,900           | 0.60                                |   |
| Other borrowings                               | 76,403                            | 112             | 0.29                                | 78,395              | 106             | 0.27                                |   |
| Advances from FHLB                             | 405,315                           | 7,173           | 3.56                                | 405,665             | 7,141           | 3.55                                |   |
| Subordinated debentures                        | 35,000                            | 490             | 2.80                                | 35,000              | 447             | 2.55                                |   |
| Total interest-bearing liabilities             | 2,524,968                         | 11,659          | 0.93                                | 2,502,376           | 13,594          | 1.10                                |   |
| Noninterest-bearing demand deposits            | 670,557                           |                 |                                     | 594,835             |                 |                                     |   |
| Other liabilities                              | 24,752                            |                 |                                     | 25,676              |                 |                                     |   |
| Stockholders' equity                           | 452,871                           |                 |                                     | 410,837             |                 |                                     |   |
| Total liabilities and stockholders' equity     | \$3,673,148                       |                 |                                     | \$3,533,724         |                 |                                     |   |

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|                                 |          |      |   |          |      |   |
|---------------------------------|----------|------|---|----------|------|---|
| Net interest income and spread  | \$61,230 | 3.34 | % | \$58,898 | 3.35 | % |
| Less: tax-equivalent adjustment | 2,716    |      |   | 2,734    |      |   |
| Net interest income             | \$58,514 |      |   | \$56,164 |      |   |
| Interest income/earning assets  |          | 4.27 | % |          | 4.45 | % |
| Interest expense/earning assets |          | 0.68 |   |          | 0.83 |   |
| Net interest margin             |          | 3.59 | % |          | 3.62 | % |

Tax-equivalent income has been adjusted using the combined marginal federal and state rate of 39.88% for 2012 (1) and 2011. The annualized taxable-equivalent adjustments utilized in the above table to compute yields aggregated to \$2.7 million and \$2.7 million in 2012 and 2011, respectively.

(2) Includes residential mortgage loans held for sale. Home equity loans and lines are classified as consumer loans.

(3) Non-accrual loans are included in the average balances.

(4) Includes only investments that are exempt from federal taxes.

## Results of Operations

### For the Six Months Ended June 30, 2012 Compared to the Six Months Ended June 30, 2011

Net income for the Company for the first six months of 2012 totaled \$15.7 million (\$0.65 per diluted share) compared to net income of \$15.6 million (\$0.65 per diluted share) for the first six months of 2011.

### Net Interest Income

The largest source of the Company's operating revenue is net interest income, which is the difference between the interest earned on interest-earning assets and the interest paid on interest-bearing liabilities. For purposes of this discussion and analysis, the interest earned on tax-exempt investment securities has been adjusted to an amount comparable to interest subject to normal income taxes. The result is referred to as tax-equivalent interest income and tax-equivalent net interest income. The following discussion of net interest income should be considered in conjunction with the review of the information provided in the preceding table.

Net interest income for the first six months of 2012 was \$58.5 million compared to \$56.2 million for the same period of 2011. On a tax-equivalent basis, net interest income increased by 4% for the first six months of 2012 to \$61.2 million from \$58.9 million for the prior year period. The preceding table provides an analysis of net interest income performance that reflects a net interest margin that decreased to 3.59% for the first six months of 2012 compared to 3.62% for the first six months of 2011. Average interest-earning assets increased by 5% while average interest-bearing liabilities increased 1% in 2012. Average noninterest-bearing deposits increased 13% in the first half of 2012 while the percentage of average noninterest-bearing deposits to total deposits also increased to 25% for the first six months of 2012 compared to 23% for the first six months of 2011.

### Effect of Volume and Rate Changes on Net Interest Income

The following table analyzes the reasons for the changes from year-to-year in the principal elements that comprise net interest income:

|   | Six Months Ended June 30,<br>2012 vs. 2011 |                               |             | 2011 vs. 2010                |                               |             |
|---|--|-------------------------------|-------------|------------------------------|-------------------------------|-------------|
|   | Increase<br>Or<br>(Decrease)               | Due to Change In<br>Average:* | Rate        | Increase<br>Or<br>(Decrease) | Due to Change In<br>Average:* | Rate        |
| (Dollars in thousands and tax equivalent) |  |                               |             |                              |                               |             |
| Interest income from earning assets:      |  |                               |             |                              |                               |             |
| Loans and leases                          | \$1,754                                    | \$ 4,083                      | \$ (2,329 ) | \$(4,779)                    | \$ (2,979 )                   | \$ (1,800 ) |



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|  |         |          |             |          |          |           |
|--|---------|----------|-------------|----------|----------|-----------|
| Securities                                     | (1,363) | (312 )   | (1,051 )    | 298      | 1,822    | (1,524 )  |
| Other earning assets                           | 6       | 6        | -           | (58 )    | (67 )    | 9         |
| Total interest income                          | 397     | 3,777    | (3,380 )    | (4,539)  | (1,224 ) | (3,315 )  |
| Interest expense on funding of earning assets: |         |          |             |          |          |           |
| Interest-bearing demand deposits               | (5 )    | 24       | (29 )       | 1        | 26       | (25 )     |
| Regular savings deposits                       | 9       | 16       | (7 )        | 8        | 11       | (3 )      |
| Money market savings deposits                  | (973 )  | 15       | (988 )      | (925 )   | (140 )   | (785 )    |
| Time deposits                                  | (1,047) | (284 )   | (763 )      | (3,042)  | (1,006 ) | (2,036 )  |
| Total borrowings                               | 81      | (30 )    | 111         | (161 )   | (212 )   | 51        |
| Total interest expense                         | (1,935) | (259 )   | (1,676 )    | (4,119)  | (1,321 ) | (2,798 )  |
| Net interest income                            | \$2,332 | \$ 4,036 | \$ (1,704 ) | \$(420 ) | \$ 97    | \$ (517 ) |

\* Variances that are the combined effect of volume and rate, but cannot be separately identified, are allocated to the volume and rate variances based on their respective relative amounts.

#### Interest Income

The Company's total tax-equivalent interest income remained essentially level for the first six months of 2012 compared to the prior year period. The previous table shows that, in 2012, the increase in average loans and leases and investments offset a decline in earning asset yields with respect to both the loan and investment portfolios which resulted in only a minimal change in total tax-equivalent interest income.

In the first six months of 2012, the average balance of the loan portfolio, including residential mortgage loans held for sale, increased 8% compared to the prior year period due to growth in all segments of the commercial and mortgage portfolios, excluding leases. This growth was primarily in the owner occupied and investor real estate, commercial business and residential construction portfolios. These increases were driven by a slowly improving regional economy and by loans added from the CommerceFirst acquisition in the second quarter of 2012. The yield on average loans and leases decreased by 21 basis points due to the continued prevailing low interest rate environment as relatively higher rate loans were paid off and new loans were originated at comparatively lower rates. The decline in the portfolio yield was driven primarily by a combined decrease of 42 basis points in the combined residential mortgage and construction loan portfolios together with a decrease of 17 basis points in the yield in the overall commercial loan portfolio.

The average yield on total investment securities decreased 19 basis points while the average balance of the portfolio decreased 2% or \$19 million in the first six months of 2012 compared to the first six months of 2011. The decline in investments was necessary to fund growth in the loan portfolio and the CommerceFirst acquisition in the second quarter of 2012. The decrease in the yield on investments was due primarily to maturities and calls of securities that were replaced by lower yielding investments as a result of lower overall market rates.

#### Interest Expense

Interest expense decreased by \$1.9 million or 14% in the first six months of 2012 compared to the first six months of 2011, primarily as a result of a 17 basis point decrease in the average rate paid on deposits and borrowings. Deposit activity was driven by the CommerceFirst acquisition and by clients' emphasis on safety and liquidity as average total deposits increased 4% for the six months compared to the prior year period. This increase was driven by an increase of \$119 million or 13% in average noninterest-bearing and interest-bearing checking accounts as clients kept funds in short-term instruments to preserve liquidity. This growth was partially offset by a decrease in average certificates of deposits of \$52 million or 8% in the first half of 2012 compared to the first half of 2011. This decrease was primarily due to a decline in the rates offered on certificates as the Company continued to manage its net interest margin in a low rate environment. This offset the positive effect of the certificates of deposit added as a result of the CommerceFirst acquisition. Average balances of money market accounts remained virtually level during the first six months of 2012 compared to the first six months of 2011.

#### Non-interest Income

Non-interest income amounts and trends are presented in the following table for the periods indicated:

| (Dollars in thousands)                                | Six Months Ended June 30, 2012 |        |                        |                       |
|---|--------------------------------|--------|------------------------|-----------------------|
|   | 2012                           | 2011   | 2012/2011<br>\$ Change | 2012/2011<br>% Change |
| Securities gains                                      | \$ 163                         | \$ 52  | \$ 111                 | - %                   |
| Total other-than-temporary impairment ("OTTI") losses | (72 )                          | (102 ) | 30                     | (29.4 )               |
|   | -                              | 18     | (18 )                  | (100.0 )              |

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Portion of OTTI losses recognized in other comprehensive income  
before taxes

|                                       |          |          |          |         |
|---------------------------------------|----------|----------|----------|---------|
| Net OTTI recognized in earnings       | (72 )    | (84 )    | 12       | (14.3 ) |
| Service charges on deposit accounts   | 4,483    | 4,689    | (206 )   | (4.4 )  |
| Mortgage banking activities           | 2,313    | 1,263    | 1,050    | 83.1    |
| Wealth management income              | 8,091    | 7,668    | 423      | 5.5     |
| Insurance agency commissions          | 2,136    | 2,133    | 3        | 0.1     |
| Income from bank owned life insurance | 1,294    | 1,300    | (6 )     | (0.5 )  |
| Visa check fees                       | 1,860    | 1,783    | 77       | 4.3     |
| Other income                          | 2,199    | 1,990    | 209      | 10.5    |
| Total non-interest income             | \$22,467 | \$20,794 | \$ 1,673 | 8.0     |

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Total non-interest income was \$22.5 million for the first six months of 2012 compared to \$20.8 million for the first six months of 2011. As shown in the table above, the primary drivers of non-interest income for the first half of 2012 were increases in income from mortgage banking activities and wealth management income.

Income from mortgage banking activities increased in the first six months of 2012 compared to the first six months of 2011 due primarily to higher loan origination volumes and higher average gains on sales, both due to increased refinancing activity during the quarter. In addition, other noninterest income increased 11% over the prior year period due mainly to higher fees from loan prepayments and other fees.

During the first six months of 2012, wealth management revenues, comprised of trust and investment management fees and fees on sales on investment products and services increased 6% compared to the prior year period. Trust services fees increased 14% compared to the prior year period, due to an increase in average assets under management and other one-time fees. Investment management fees in West Financial Services remained level for the first six months of 2012 compared to the six months ended June 30, 2011. Fees on sales of investment products and services decreased 2% for the year-to-date as assets under management declined. Overall total assets under management of \$2.1 billion for West Financial Services, trust and investment services remained relatively level at June 30, 2012 compared to June 30, 2011.

Service charges on deposits decreased for the first six months of 2012 compared to the prior year period due primarily to a decline in overdraft fees. Insurance agency commission revenue declined in the first six months of 2012 compared to the first six months of 2011 due mainly to decreases in commissions from annuities and bonds which were somewhat offset by an increase in commissions on commercial lines.

Income from bank owned life insurance remained virtually even for the first six months of 2012 compared to the prior year period. The Company invests in bank owned life insurance products in order to better manage the cost of employee benefit plans. Investments totaled \$82.4 million at June 30, 2012 and \$79.8 million at June 30, 2011 and were well diversified by carrier in accordance with defined policies and practices. The average tax-equivalent yield on these insurance contract assets was 5.30% for the first six months of 2012 compared to 5.52% for the first six months of 2011.

Net OTTI losses recognized in earnings in the first six months of 2012 were \$72 thousand compared to \$102 thousand for the prior year period. This was largely due to improved performance by the banks and thrifts whose debt backs one pooled trust preferred security which was responsible for the OTTI charges during the first six months of both 2012 and 2011. The Company recognized net securities gains, exclusive of net OTTI losses mentioned above, reflected in the preceding table, which resulted primarily from securities sales and calls during the period.



**Non-interest Expense**

Non-interest expense amounts and trends are presented in the following table for the years indicated:

| (Dollars in thousands)            | Six Months Ended June 30, 2012 |          |                        |                       |
|-----------------------------------|--------------------------------|----------|------------------------|-----------------------|
|                                   | 2012                           | 2011     | 2012/2011<br>\$ Change | 2012/2011<br>% Change |
| Salaries and employee benefits    | \$31,628                       | \$29,300 | \$ 2,328               | 7.9 %                 |
| Occupancy expense of premises     | 5,789                          | 5,933    | (144 )                 | (2.4 )                |
| Equipment expenses                | 2,445                          | 2,270    | 175                    | 7.7                   |
| Marketing                         | 1,060                          | 1,194    | (134 )                 | (11.2 )               |
| Outside data services             | 3,107                          | 1,994    | 1,113                  | 55.8                  |
| FDIC insurance                    | 1,305                          | 1,780    | (475 )                 | (26.7 )               |
| Amortization of intangible assets | 927                            | 923      | 4                      | 0.4                   |
| Professional fees                 | 3,443                          | 2,214    | 1,229                  | 55.5                  |
| Other real estate owned           | 415                            | 1,425    | (1,010 )               | (70.9 )               |
| Other expenses                    | 5,422                          | 4,867    | 555                    | 11.4                  |
| Total non-interest expense        | \$55,541                       | \$51,900 | \$ 3,641               | 7.0                   |

Non-interest expenses totaled \$55.5 million in the first six months of 2012 compared to \$51.9 million in the first six months of 2011, an increase of 7%. This growth in expenses was due primarily to increases in salaries and benefits expenses, outside data services costs and professional fees. These increases were due primarily to merger expenses incurred in conjunction with the CommerceFirst acquisition and were partially offset by a reduction in FDIC expenses due primarily to a regulatory change in the calculation of such premiums that was effective with the second quarter of 2011.

Salaries and employee benefits, the largest component of non-interest expenses, increased in the first six months of 2012 due primarily to higher compensation expenses as a result of the CommerceFirst acquisition and due to merit increases and higher commission compensation expenses related to organic growth in specific product offerings compared to the prior year. Average full-time equivalent employees remained relatively constant in the first half of 2012 compared to the first half of 2011.

Outside data services expenses increased in the first six months of 2012 compared to the prior year period due primarily to software expenses related to the Company's merger with CommerceFirst. Occupancy expenses decreased for the first six months of 2012 compared to the first six months of 2011 due to lower grounds maintenance and utilities expenses as a result of unseasonably mild weather during the first half of 2012. Equipment expenses increased for the first six months over the prior year period due to higher software expenses. Marketing expenses and amortization of intangible assets remained virtually level in the first six months of 2012 compared to the first six months of 2011. The Company's intangible assets are being amortized over relatively short amortization periods averaging approximately 2.3 years at June 30, 2012.

FDIC insurance expense decreased in the first six months of 2012 compared to the first six months of 2011 due to a regulatory change in the calculation of such premiums that was effective with the second quarter of 2011. Professional fees increased in the first six months of 2012 compared to the first six months of 2011 due primarily to higher legal and consulting fees related to the CommerceFirst acquisition mentioned above and from loan workouts.

Other real estate owned expenses decreased in the first six months of 2012 compared to the first six months of 2011 due to losses on sales of other real estate owned incurred in the first six months of 2011 as the Company sold nonperforming assets at that time. Other non-interest expenses increased in the first six months of 2012 compared to the first six months of 2011 due mainly to an increase in other accrued expenses.

## Income Taxes

The Company had income tax expense of \$7.5 million in the first six months of 2012 compared to expense of \$6.8 million in the first six months of 2011. The resulting effective rates were 32% for the first six months of 2012 and 30% for the first six months of 2011. The increase in the effective tax rate in the first half of 2012 was due primarily to certain merger expenses relating to the CommerceFirst acquisition that are not tax deductible.

## Results of Operations

### **For the Quarter Ended June 30, 2012 Compared to the Quarter Ended June 30, 2011**

Net income for the second quarter of 2012 totaled \$7.2 million (\$0.30 per diluted share) compared to net income of \$8.3 million (\$0.34 per diluted share) for the second quarter of 2011.

Net interest income for the first second quarter of 2012 was \$29.8 million compared to \$28.2 million for the second quarter of 2011. On a tax-equivalent basis, net interest income increased by 5% for the second quarter of 2012 to \$31.1 million from \$29.6 million for the prior year quarter. The net interest margin increased to 3.62% for the second quarter of 2012 compared to 3.58% for the second quarter of 2011. Average interest-earning assets increased by 4% while average interest-bearing liabilities increased less than 1% in for the second quarter of 2012 compared to 2011. Average noninterest-bearing deposits increased 15% in the second quarter of 2012 while the percentage of average noninterest-bearing deposits to total deposits also increased to 26% for the second quarter of 2012 compared to 23% for the second quarter of 2011.

## Interest Income

The Company's total tax-equivalent interest income remained essentially level for the second quarter of 2012 at \$36.9 million compared to the second quarter of 2011. The increase in average loans and leases was offset by a decrease in the average balance of the investment portfolio together with a decline in earning asset yields with respect to both the loan and investment portfolios. These factors resulted in virtually no change in total tax-equivalent interest income.

In the first quarter of 2012, the average balance of the loan portfolio increased 10% compared to the prior year period due to growth in all segments of the commercial and mortgage portfolios, excluding leases. This growth occurred primarily in the owner occupied and investor real estate, commercial business and the residential construction portfolios. These increases were driven by organic loan growth and by the CommerceFirst acquisition in the second quarter of 2012. The yield on average loans and leases decreased by 16 basis points due to the continued prevailing low interest rate environment as relatively higher rate loans were paid off and new loans were originated at comparatively lower rates. The decline in the portfolio yield was driven primarily by a combined decrease of 34 basis points in the combined residential mortgage and construction loan portfolios together with a decrease of 13 basis



points in the yield in the overall commercial loan portfolio.

The average yield on total investment securities decreased 21 basis points while the average balance of the portfolio increased 6% or \$69 million in the second quarter of 2012 compared to the second quarter of 2011. The decline in investments was due to sales and calls during the first six months of 2012 to fund both the increase in the loan portfolio and the CommerceFirst acquisition. The decrease in the yield on investments was due primarily to maturities and calls of securities that were replaced by lower yielding investments as a result of lower overall market rates.

#### Interest Expense

Interest expense decreased by \$1.1 million or 16% in the second quarter of 2012 compared to the second quarter of 2011, primarily as a result of an 18 basis point decrease in the average rate paid on deposits and borrowings. Deposit activity was affected by the CommerceFirst acquisition and clients' emphasis on safety and liquidity as average total deposits increased 4% for the quarter compared to the prior year period. This increase was driven by an increase of \$134 million or 14% in average noninterest-bearing and interest-bearing checking accounts as clients kept funds in short-term instruments to preserve liquidity. This growth was partially offset by a decrease in average certificates of deposits of \$56 million or 9% in the second quarter of 2012 compared to the second quarter of 2011. This decrease was primarily due to a decline in the rates offered on certificates as the Company continued to manage its net interest margin in a low rate environment but was partially offset by growth due to the CommerceFirst acquisition. Average balances of money market accounts remained level during the second quarter of 2012 compared to the second quarter of 2011.

**Non-interest Income**

Non-interest income amounts and trends are presented in the following table for the periods indicated:

| (Dollars in thousands)   | Three Months Ended June 30, 2012 |           |           |          |
|--|----------------------------------|-----------|-----------|----------|
|  | 2012                             | 2011      | \$ Change | % Change |
| Securities gains   | \$90                             | \$32      | \$ 58     | 181.3 %  |
| Total other-than-temporary impairment ("OTTI") losses                        | (8 )                             | (43 )     | 35        | (81.4 )  |
| Portion of OTTI losses recognized in other comprehensive income before taxes | -                                | -         | -         | -        |
| Net OTTI recognized in earnings  | (8 )                             | (43 )     | 35        | (81.4 )  |
| Service charges on deposit accounts  | 2,283                            | 2,437     | (154 )    | (6.3 )   |
| Mortgage banking activities  | 1,288                            | 808       | 480       | 59.4     |
| Wealth management income   | 4,034                            | 4,023     | 11        | 0.3      |
| Insurance agency commissions   | 934                              | 953       | (19 )     | (2.0 )   |
| Income from bank owned life insurance  | 660                              | 654       | 6         | 0.9      |
| Visa check fees  | 962                              | 949       | 13        | 1.4      |
| Other income   | 1,250                            | 989       | 261       | 26.4     |
| Total non-interest income  | \$ 11,493                        | \$ 10,802 | \$ 691    | 6.4      |

Total non-interest income was \$11.5 million for the second quarter of 2012 compared to \$10.8 million in the second quarter of 2011. As shown in the table above, the primary driver of non-interest income for the second quarter of 2012 was an increase in income from mortgage banking activities due to higher loan origination volumes and higher average gains on sales, both due to increased refinancing activity during the quarter. In addition, other non-interest income increased 26% over the prior year quarter due mainly to higher fees from loan prepayments and other fees.

During the second quarter of 2012, wealth management income remained level with the prior year quarter. Trust services fees increased 12% compared to the prior year period due to an increase in assets under management and other one-time fees. Investment management fees in West Financial Services remained level for the quarter compared to the quarter ended June 30, 2011. Fees on sales of investment products and services decreased 16% for the quarter as assets under management declined during the second quarter of 2012.

Service charges on deposits decreased 6% for the quarter compared to the prior year period due primarily to a decline in overdraft fees.

Net OTTI losses recognized in earnings in the second quarter of 2012 were \$8 thousand compared to \$43 thousand for the prior year quarter. This was largely due to improved performance by the banks and thrifts whose debt backs one

pooled trust preferred security which was solely responsible for all OTTI charges during the first quarters of both 2012 and 2011. The Company recognized net securities gains, exclusive of net OTTI losses mentioned above, reflected in the preceding table, which resulted primarily from securities called during the quarter due to the current historically low interest rate environment.

All other segments of non-interest income remained essentially level with the prior year quarter as can be seen from the above table.

**Non-interest Expense**

Non-interest expense amounts and trends are presented in the following table for the years indicated:

| (Dollars in thousands)            | Three Months Ended June 30, 2012 |           |           |              |
|-----------------------------------|----------------------------------|-----------|-----------|--------------|
|                                   | 2012                             | 2011      | 2012/2011 | 2012/2011    |
|                                   |                                  |           | \$ Change | % Change     |
| Salaries and employee benefits    | \$ 15,927                        | \$ 14,676 | \$ 1,251  | <b>8.5</b> % |
| Occupancy expense of premises     | 2,943                            | 2,790     | 153       | 5.5          |
| Equipment expenses                | 1,255                            | 1,128     | 127       | 11.3         |
| Marketing                         | 565                              | 709       | (144 )    | (20.3 )      |
| Outside data services             | 1,828                            | 999       | 829       | 83.0         |
| FDIC insurance                    | 653                              | 736       | (83 )     | (11.3 )      |
| Amortization of intangible assets | 466                              | 462       | 4         | 0.9          |
| Professional fees                 | 2,156                            | 1,088     | 1,068     | 98.2         |
| Other real estate owned           | 351                              | 726       | (375 )    | (51.7 )      |
| Postage and delivery              | 2,714                            | 2,524     | 190       | 7.5          |
| Total non-interest expense        | \$ 28,858                        | \$ 25,838 | \$ 3,020  | 11.7         |

Non-interest expenses increased 12% in the second quarter of 2012 compared to the second quarter of 2011. This growth in expenses was driven by increases in salary and benefits expenses, outside data services costs and professional fees as a result of the CommerceFirst acquisition. These increases were partially offset by a reduction in FDIC expenses compared to the prior year quarter.

Salaries and employee benefits increased in the second quarter of 2012 due primarily to higher compensation expenses as a result of merger expenses related to the CommerceFirst acquisition together with merit increases and higher commission compensation expenses related to organic growth in specific product offerings compared to the prior year. Average full-time equivalent employees remained relatively constant in the second quarter of 2012 compared to the second quarter of 2011 as reductions due to efficiency improvements were offset by employees added in the CommerceFirst acquisition. Outside data services increased in the second quarter of 2012 compared to the second quarter of 2011 due primarily to software and systems conversion expenses related to the Company's merger with CommerceFirst Bank.

Occupancy expenses increased 6% for the second quarter of 2012 compared to the second quarter of 2011 due to higher rent expenses from new branch openings and five branches added as a result of the CommerceFirst acquisition. Equipment expenses increased 11% for the quarter over the prior year period due to higher software expenses. Marketing expenses decreased 20% for the quarter compared to the prior year quarter due to timing of such expenditures.

FDIC insurance expense decreased 11% in the second quarter of 2012 compared to the second quarter of 2011 due to improved financial ratios, which are used in the calculation of such expense, compared to the prior year period.

Professional fees increased in the second quarter of 2012 compared to the second quarter of 2011 due primarily to higher legal and consulting fees related to the CommerceFirst acquisition mentioned above and from loan workouts.

Other real estate owned expenses increased in the second quarter of 2012 compared to the second quarter of 2011 due to maintenance expenses on such properties and valuation adjustments incurred in the quarter.

### **Income Taxes**

The Company had income tax expense of \$3.7 million in both the second quarter of 2012 and 2011. The resulting effective rates were 34% for the second quarter of 2012 and 31% for the second quarter of 2011. The increase in the effective tax rate in the second quarter of 2012 compared to the second quarter of 2011 was due primarily to certain merger expenses incurred in the second quarter of 2012 that are not tax deductible.

### Operating Expense Performance

Management views the GAAP efficiency ratio as an important financial measure of expense performance and cost management. The ratio expresses the level of non-interest expenses as a percentage of total revenue (net interest income plus total non-interest income). Lower ratios indicate improved productivity.

### Non-GAAP Financial Measure

The Company also uses a traditional efficiency ratio that is a non-GAAP financial measure of operating expense control and efficiency of operations. Management believes that its traditional ratio better focuses attention on the operating performance of the Company over time than does a GAAP ratio, and is highly useful in comparing period-to-period operating performance of the Company's core business operations. It is used by management as part of its assessment of its performance in managing non-interest expenses. However, this measure is supplemental, and is not a substitute for an analysis of performance based on GAAP measures. The reader is cautioned that the non-GAAP efficiency ratio used by the Company may not be comparable to GAAP or non-GAAP efficiency ratios reported by other financial institutions.

In general, the efficiency ratio is non-interest expenses as a percentage of net interest income plus non-interest income. Non-interest expenses used in the calculation of the non-GAAP efficiency ratio exclude goodwill impairment losses, the amortization of intangibles, and non-recurring expenses. Income for the non-GAAP ratio includes the favorable effect of tax-exempt income, and excludes securities gains and losses, which vary widely from period to period without appreciably affecting operating expenses, and non-recurring gains. The measure is different from the GAAP efficiency ratio, which also is presented in this report. The GAAP measure is calculated using non-interest expense and income amounts as shown on the face of the Consolidated Statements of Income. The GAAP and non-GAAP efficiency ratios are reconciled and provided in the following table. The non-GAAP efficiency ratio decreased in both the second quarter and first six months of 2012 compared to the respective prior year periods due primarily to an increase in net interest income. The GAAP efficiency ratio increased for the respective periods in 2012 compared to 2011 due to higher non-interest expenses resulting from merger expenses incurred due to the CommerceFirst acquisition.

**GAAP and Non-GAAP Efficiency Ratios**

| (Dollars in thousands)                                     | Three Months Ended |          | Six Months Ended |          |
|--|--------------------|----------|------------------|----------|
|  | June 30,<br>2012   | 2011     | June 30,<br>2012 | 2011     |
| GAAP efficiency ratio:                                     |                    |          |                  |          |
| Non-interest expenses                                      | \$28,858           | \$25,838 | \$55,541         | \$51,900 |
| Net interest income plus non-interest income               | \$41,302           | \$38,956 | \$80,981         | \$76,958 |
| GAAP Efficiency ratio                                      | 69.87 %            | 66.33 %  | 68.59 %          | 67.44 %  |
| Non-GAAP efficiency ratio:                                 |                    |          |                  |          |
| Non-interest expenses                                      | \$28,858           | \$25,838 | \$55,541         | \$51,900 |
| Less non-GAAP adjustment:                                  |                    |          |                  |          |
| Amortization of intangible assets                          | 466                | 462      | 927              | 923      |
| Merger expenses  | 2,198              | -        | 2,572            | -        |
| Non-interest expenses - as adjusted                        | \$26,194           | \$25,376 | \$52,042         | \$50,977 |
| Net interest income plus non-interest income               | \$41,302           | \$38,956 | \$80,981         | \$76,958 |
| Plus non-GAAP adjustment:                                  |                    |          |                  |          |
| Tax-equivalent income                                      | 1,340              | 1,427    | 2,716            | 2,734    |
| Less non-GAAP adjustments:                                 |                    |          |                  |          |
| Securities gains   | 90                 | 32       | 163              | 52       |
| OTTI recognized in earnings                                | (8 )               | (43 )    | (72 )            | (84 )    |
| Net interest income plus non-interest income - as adjusted | \$42,560           | \$40,394 | \$83,606         | \$79,724 |
| Non-GAAP Efficiency ratio                                  | 61.54 %            | 62.82 %  | 62.25 %          | 63.94 %  |

**FINANCIAL CONDITION**

The Company's total assets were \$3.9 billion at June 30, 2012, increasing \$144 million compared to \$3.7 billion at December 31, 2011. Interest-earning assets increased \$132 million to \$3.6 billion at June 30, 2012 compared to December 31, 2011. The increase in interest-earning assets was primarily due to the CommerceFirst acquisition in the second quarter of 2012 which added \$172 million in interest-earning assets.

## Analysis of Loans and Leases

A comparison of loan portfolio at the dates indicated is presented in the following table:

| (Dollars in thousands)                               | June 30, 2012 |         | December 31, 2011 |         | Period-to-Period Change |          |
|--|---------------|---------|-------------------|---------|-------------------------|----------|
|  | Amount        | %       | Amount            | %       | \$ Change               | % Change |
| Residential real estate:                             |               |         |                   |         |                         |          |
| Residential mortgage                                 | \$472,426     | 19.1 %  | \$448,662         | 20.0 %  | \$ 23,764               | 5.3 %    |
| Residential construction                             | 130,791       | 5.3     | 108,699           | 4.9     | 22,092                  | 20.3     |
| Commercial real estate:                              |               |         |                   |         |                         |          |
| Commercial owner occupied real estate                | 579,812       | 23.5    | 522,076           | 23.3    | 57,736                  | 11.1     |
| Commercial investor real estate                      | 443,237       | 17.9    | 371,948           | 16.6    | 71,289                  | 19.2     |
| Commercial acquisition, development and construction | 151,620       | 6.1     | 160,946           | 7.2     | (9,326 )                | (5.8 )   |
| Commercial Business                                  | 334,040       | 13.5    | 260,327           | 11.6    | 73,713                  | 28.3     |
| Leases   | 5,618         | 0.2     | 6,954             | 0.3     | (1,336 )                | (19.2 )  |
| Consumer   | 357,534       | 14.4    | 360,080           | 16.1    | (2,546 )                | (0.7 )   |
| Total loans and leases                               | \$2,475,078   | 100.0 % | \$2,239,692       | 100.0 % | \$ 235,386              | 10.5     |

Total loans and leases, excluding loans held for sale, increased \$235.4 million or 11% during the first six months of 2012 compared to December 31, 2011. Excluding the loans acquired through the CommerceFirst transaction, total loans and leases increased \$69.7 million or 3%. The residential real estate portfolio, which is comprised of residential construction and permanent residential mortgage loans, reflected an 8% increase at June 30, 2012 compared to December 31, 2011. Permanent residential mortgages, most of which are 1-4 family, increased 5% due to higher loan origination volumes of adjustable rate mortgage loans. The Company generally retains such adjustable rate mortgages in its portfolio and sells the fixed rate mortgages that it originates in the secondary mortgage market. Residential construction loans increased 20% at June 30, 2012 compared to the balance at December 31, 2011 due to increased construction activity as a result of an improving regional economy and mild weather conditions.

The commercial loan portfolio increased by \$192.1 million to \$1.5 billion at June 30, 2012 compared to the prior year end largely due to the CommerceFirst acquisition. Excluding the commercial loans added through the CommerceFirst acquisition, the commercial loan portfolio increased \$26.4 million or 2%. The increase in commercial loans compared to the prior year end was due primarily to a 28% increase in commercial business loans and a 19% increase in commercial investor real estate loans, while commercial owner occupied real estate loans reflected a more limited increase of 11% at June 30, 2012 compared to December 31, 2011. Commercial ADC loans decreased 6% at June 30, 2012 compared to December 31, 2011. Excluding the effect of the CommerceFirst acquisition, these trends in the commercial loan portfolio are reflective of the current uneven economic recovery and the intense competition for quality loans in the region in which the Company operates.

The consumer loan portfolio decreased 1% at June 30, 2012 compared to December 31, 2011. Equity lines of credit increased 1% during the first six months of 2012. This increase was offset by declines in all other segments of the



consumer portfolio due to weak consumer demand due to the state of the regional and national economy.

The investment portfolio, consisting of available-for-sale, held-to-maturity and other equity securities, decreased 14% to \$1.0 billion at June 30, 2012, from \$1.2 billion at December 31, 2011. This decrease was due primarily to sales and calls of securities during the first six months of 2012 to fund both the increase in the loan portfolio and the CommerceFirst acquisition.

## Analysis of Investment Securities

The composition of investment securities for the periods indicated is presented in the following table:

| (Dollars in thousands)                    | June 30, 2012 |        | December 31, 2011 |        | Period-to-Period Change |          |
|---|---------------|--------|-------------------|--------|-------------------------|----------|
|   | Amount        | %      | Amount            | %      | \$ Change               | % change |
| <b>Available-for-Sale:</b>                |               |        |                   |        |                         |          |
| U.S. government agencies and corporations | \$121,620     | 12.1 % | \$200,252         | 17.2 % | \$ (78,632 )            | (39.3 )% |
| State and municipal                       | 171,706       | 17.1   | 173,111           | 14.9   | (1,405 )                | (0.8 )   |
| Mortgage-backed                           | 509,534       | 50.6   | 570,144           | 48.9   | (60,610 )               | (10.6 )  |
| Corporate debt                            | 1,995         | 0.2    | 1,978             | 0.2    | 17                      | 0.9      |
| Trust preferred                           | 3,303         | 0.3    | 5,716             | 0.5    | (2,413 )                | (42.2 )  |
| Marketable equity securities              | 723           | -      | 100               | -      | 623                     | -        |
| Total available-for-sale                  | 808,881       | 80.3   | 951,301           | 81.7   | (142,420 )              | (15.0 )  |
| <b>Held-to-Maturity and Other Equity</b>  |               |        |                   |        |                         |          |
| U.S. government agencies and corporations | 37,576        | 3.8    | 54,983            | 4.7    | (17,407 )               | (31.7 )  |
| State and municipal                       | 126,904       | 12.6   | 123,075           | 10.6   | 3,829                   | 3.1      |
| Mortgage-backed                           | 366           | -      | 407               | -      | (41 )                   | (10.1 )  |
| Other equity securities                   | 33,016        | 3.3    | 34,933            | 3.0    | (1,917 )                | (5.5 )   |
| Total held-to-maturity and other equity   | 197,862       | 19.7   | 213,398           | 18.3   | (15,536 )               | (7.3 )   |
| Total securities                          | \$1,006,743   | 100.0% | \$1,164,699       | 100.0% | \$ (157,956 )           | (13.6 )  |

The investment portfolio consists primarily of U.S. Agency securities, U.S. Agency mortgage-backed securities, U.S. Agency collateralized mortgage obligations and state and municipal securities. The duration of the portfolio was 3.5 years at June 30, 2012 and 3.1 years at December 31, 2011. The Company considers the duration of the portfolio to be adequate for liquidity purposes. This investment strategy has resulted in a portfolio with low credit risk that would provide the required liquidity should loan demand increase. The portfolio is monitored on a continuing basis with consideration given to interest rate trends and the structure of the yield curve and with constant due diligence of economic projections and analysis.

At June 30, 2012, the trust preferred portfolio included one pooled trust preferred security backed by debt issued by banks and thrifts, which totaled \$2.2 million, with a fair value of \$1.8 million. The fair value of this security was determined by a third party valuation specialist due to the limited trading activity for this security in the marketplace. The specialist used an income valuation approach technique (present value) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. The methodology, observable inputs and significant assumptions employed by the specialist to determine fair value are provided in Note 3 – Investment Securities in the Notes to the Condensed Consolidated Financial Statements.

As a result of this valuation, it was determined that the pooled trust preferred security had incurred credit-related OTTI of \$8 thousand, which was recognized in earnings for the three months ended June 30, 2012. Cumulative credit-related OTTI of \$0.5 million has been recognized in earnings through June 30, 2012. Non-credit related OTTI on this security, which is not expected to be sold and that the Company has the ability to hold until maturity, was \$0.4 million at June 30, 2012. This non-credit related OTTI was recognized in other comprehensive income (“OCI”) at June 30, 2012.

#### Other Earning Assets

Residential mortgage loans held for sale increased \$0.5 million to \$25.8 million as of June 30, 2012 from \$25.3 million as of December 31, 2011. This increase was due to higher loan volumes due to the current low interest rate environment which has led to increased refinancing activity. The aggregate of federal funds sold and interest-bearing deposits with banks increased \$54.4 million to \$76.8 million at June 30, 2012. This increase was due to liquidity provided by called securities in the investment portfolio and reduced balances at December 31, 2011 due to loan originations that occurred late in the fourth quarter of 2011.

## Deposits

The composition of deposits for the periods indicated is presented in the following table:

| (Dollars in thousands)               | June 30, 2012 |         | December 31, 2011 |         | Period-to-Period Change |          |
|--------------------------------------|---------------|---------|-------------------|---------|-------------------------|----------|
|                                      | Amount        | %       | Amount            | %       | \$ Change               | % change |
| Noninterest-bearing deposits         | \$763,566     | 26.8 %  | \$650,377         | 24.5 %  | \$ 113,189              | 17.4 %   |
| Interest-bearing deposits:           |               |         |                   |         |                         |          |
| Demand                               | 383,036       | 13.4    | 367,682           | 13.8    | 15,354                  | 4.2      |
| Money market savings                 | 885,655       | 31.0    | 858,732           | 32.3    | 26,923                  | 3.1      |
| Regular savings                      | 216,246       | 7.6     | 195,408           | 7.4     | 20,838                  | 10.7     |
| Time deposits of less than \$100,000 | 361,115       | 12.7    | 316,058           | 11.9    | 45,057                  | 14.3     |
| Time deposits of \$100,000 or more   | 242,437       | 8.5     | 268,263           | 10.1    | (25,826 )               | (9.6 )   |
| Total interest-bearing deposits      | 2,088,489     | 73.2    | 2,006,143         | 75.5    | 82,346                  | 4.1      |
| Total deposits                       | \$2,852,055   | 100.0 % | \$2,656,520       | 100.0 % | \$ 195,535              | 7.4      |

## Deposits and Borrowings

Total deposits increased \$195.5 million or 7% at June 30, 2012 compared to December 31, 2011. This growth in deposits was driven primarily by deposits added from the CommerceFirst acquisition. Excluding the deposits added through the CommerceFirst acquisition, total deposits increased \$55.3 million or 2%. Noninterest-bearing and interest-bearing checking accounts increased 13% while regular savings accounts increased 11%. Money market accounts increased 3% compared to the prior year end. The activity in these deposit products can be attributed primarily to clients' emphasis on safety and liquidity considering the current extended period of low interest rates and the volatility of alternative investments. Certificates of deposit increased 3% compared to the prior year end, primarily as a result of the CommerceFirst acquisition. Excluding the certificates added from the CommerceFirst acquisition, certificates decreased 10% as the Company managed its deposit mix to improve its net interest margin. Total borrowings decreased 14% at June 30, 2012 compared to December 31, 2011. This decrease was due primarily to the reduction of \$79.0 million in short-term borrowings from the Federal Home Loan Bank of Atlanta which were utilized primarily to temporarily fund, at very low interest rates, an increase in loans late in the fourth quarter of 2011.

## Capital Management

Management monitors historical and projected earnings, dividends and asset growth, as well as risks associated with the various types of on- and off-balance sheet assets and liabilities, in order to determine appropriate capital levels. During the first six months of 2012, total stockholders' equity increased \$25.4 million to \$471.5 million at June 30, 2012, from \$446.1 million at December 31, 2011. This increase was due primarily to stock issued in conjunction with the CommerceFirst acquisition and net income during the period. The ratio of average equity to average assets was 12.33% at June 30, 2012, as compared to 11.63% at June 30, 2011.

Bank holding companies and banks are required to maintain capital ratios in accordance with guidelines adopted by the federal bank regulators. These guidelines are commonly known as Risk-Based Capital guidelines. The actual regulatory ratios and required ratios for capital adequacy, in addition to the ratios required to be categorized as “well capitalized”, are summarized for the Company in the following table.

**Risk-Based Capital Ratios**

|  | Ratios at<br>June<br>30,<br>2012 | December 31, 2011 |   | Minimum<br>Regulatory<br>Requirements |   |
|--|----------------------------------|-------------------|---|---------------------------------------|---|
| Total Capital to risk-weighted assets  | 15.36%                           | 15.83             | % | 8.00                                  | % |
| Tier 1 Capital to risk-weighted assets | 14.12%                           | 14.57             | % | 4.00                                  | % |
| Tier 1 Leverage                        | 11.21%                           | 10.84             | % | 3.00                                  | % |

Tier 1 capital of \$406.3 million and total qualifying capital of \$442.4 million each included \$35.0 million in trust preferred securities that are considered regulatory capital for purposes of determining the Company's Tier 1 capital ratio. As of June 30, 2012, the most recent notification from the Bank's primary regulator categorized the Bank as a "well-capitalized" institution under the prompt corrective action rules of the Federal Deposit Insurance Act. Designation as a well-capitalized institution under these regulations is not a recommendation or endorsement of the Company or the Bank by federal bank regulators.

### Tangible Common Equity

Tangible equity and tangible assets and tangible book value per share are non-GAAP financial measures calculated using GAAP amounts. Tangible common equity and tangible assets exclude the balances of goodwill and other intangible assets from stockholder's equity and total assets, respectively. Management believes that this non-GAAP financial measure provides information to investors that may be useful in understanding our financial condition. Because not all companies use the same calculation of tangible equity and tangible assets, this presentation may not be comparable to other similarly titled measures calculated by other companies. A reconciliation of the non-GAAP ratio of tangible equity to tangible assets and tangible book value per share are provided in the following table.

### Tangible Common Equity Ratio – Non-GAAP

| (Dollars in thousands)                 | June 30, 2012 | December 31, 2011 |
|--|---------------|-------------------|
| Tangible common equity ratio:          |               |                   |
| Total stockholders' equity             | \$ 471,464    | \$ 446,109        |
| Accumulated other comprehensive income | (14,577 )     | (13,248 )         |
| Goodwill                               | (81,892 )     | (76,816 )         |
| Other intangible assets, net           | (4,017 )      | (4,734 )          |
| Tangible common equity                 | \$ 370,978    | \$ 351,311        |
| <br>                                   |               |                   |
| Total assets                           | \$ 3,855,177  | \$ 3,711,370      |
| Goodwill                               | (81,892 )     | (76,816 )         |
| Other intangible assets, net           | (4,017 )      | (4,734 )          |
| Tangible assets                        | \$ 3,769,268  | \$ 3,629,820      |
| <br>                                   |               |                   |
| Tangible common equity ratio           | 9.84 %        | 9.68 %            |

### Credit Risk

The fundamental lending business of the Company is based on understanding, measuring and controlling the credit risk inherent in the loan portfolio. The Company's loan and lease portfolio is subject to varying degrees of credit risk. Credit risk entails both general risks, which are inherent in the process of lending, and risk specific to individual borrowers. The Company's credit risk is mitigated through portfolio diversification, which limits exposure to any single customer, industry or collateral type. Typically, each consumer and residential lending product has a generally

predictable level of credit losses based on historical loss experience. Home mortgage and home equity loans and lines generally have the lowest credit loss experience. Loans secured by personal property, such as auto loans, generally experience medium credit losses. Unsecured loan products, such as personal revolving credit, have the highest credit loss experience and for that reason, the Company has chosen not to engage in a significant amount of this type of lending. Credit risk in commercial lending can vary significantly, as losses as a percentage of outstanding loans can shift widely during economic cycles and are particularly sensitive to changing economic conditions. Generally, improving economic conditions result in improved operating results on the part of commercial customers, enhancing their ability to meet their particular debt service requirements. Improvements, if any, in operating cash flows can be offset by the impact of rising interest rates that may occur during improved economic times. Inconsistent economic conditions may have an adverse affect on the operating results of commercial customers, reducing their ability to meet debt service obligations.

Current economic data has shown that while the Mid-Atlantic region is outperforming most other markets in the nation, the Company is continuing to deal with the lingering impact of a very slowly recovering economy and its resulting effects on the Company's borrowers, particularly in the real estate sector. Total non-performing loans decreased \$14.7 million or 19% at June 30, 2012 compared to the balance at December 31, 2011. While the diversification of the lending portfolio among different commercial, residential and consumer product lines along with different market conditions of the D.C. suburbs, Northern Virginia and Baltimore metropolitan area has mitigated some of the risks in the portfolio, local economic conditions and levels of non-performing loans may continue to be influenced by the current slow and uneven economic recovery on both a regional and national level.

To control and manage credit risk, management has a credit process in place to reasonably ensure credit standards are maintained along with an in-house loan administration accompanied by oversight and review procedures. The primary purpose of loan underwriting is the evaluation of specific lending risks and involves the analysis of the borrower's ability to service the debt as well as the assessment of the value of the underlying collateral. Oversight and review procedures include the monitoring of portfolio credit quality, early identification of potential problem credits and the aggressive management of problem credits. As part of the oversight and review process, the Company maintains an allowance for loan and lease losses (the "allowance") to absorb estimated and probable losses in the loan and lease portfolio. The allowance is based on consistent, continuous review and evaluation of the loan and lease portfolio, along with ongoing, monthly assessments of the probable losses and problem credits in each portfolio.

The allowance represents an estimation of the losses that are inherent in the loan and lease portfolio. The adequacy of the allowance is determined through careful and ongoing evaluation of the credit portfolio, and involves consideration of a number of factors, as outlined below, to establish an adequate allowance for loan losses. Determination of the allowance is inherently subjective and requires significant estimates, including estimated losses on pools of homogeneous loans and leases based on historical loss experience and consideration of current economic trends, which may be susceptible to significant change. Loans and leases deemed uncollectible are charged against the allowance, while recoveries are credited to the allowance. Management adjusts the level of the allowance through the provision for loan and lease losses, which is recorded as a current period operating expense.

The methodology for assessing the appropriateness of the allowance includes: (1) a general allowance that reflects historical losses, as adjusted, by credit category, and (2) a specific allowance for impaired credits on an individual or portfolio basis. This methodology is further described in the section entitled "Critical Accounting Policies" and in "Note 1 – Significant Accounting Policies" of the Notes to the Consolidated Financial Statements of the Company's 2011 Form 10-K. The amount of the allowance is reviewed monthly and approved quarterly by the Credit and Investment Risk Committee of the board of directors.

The Company recognizes a collateral dependent lending relationship as non-performing when either the loan becomes 90 days delinquent or as a result of factors (such as bankruptcy, interruption of cash flows, etc.) considered at the monthly credit committee meeting. When a commercial loan is placed on non-accrual status, it is considered to be impaired and all accrued but unpaid interest is reversed. However, not all impaired loans are in non-accrual status because they may be current with regard to the payment terms. Classification as an impaired loan is based on a determination that the Company may not collect all principal and interest payments according to contractual terms. Impaired loans exclude large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment such as leases, residential real estate and consumer loans. Typically, all payments received on non-accrual loans are applied to the remaining principal balance of the loans. Integral to the assessment of the allowance process is an evaluation that is performed to determine whether a specific allowance on an impaired loan is warranted and, when losses are confirmed, a charge-off is taken to reduce the loan to its net realizable value. Any further collateral deterioration results in either further specific allowances being established or additional charge-offs. At such time an action plan is agreed upon for the particular loan and an appraisal will be ordered depending on the time elapsed since the prior appraisal, the loan balance and/or the result of the internal evaluation. A current appraisal on large loans is usually obtained if the appraisal on file is more than 12 months old and there has been a material change in market conditions, zoning, physical use or the adequacy of the collateral based on an internal evaluation. The Company's



policy is to strictly adhere to regulatory appraisal standards. If an appraisal is ordered, no more than a 30 day turnaround is requested from the appraiser, who is selected by Credit Administration from an approved appraiser list. After receipt of the updated appraisal, the assigned credit officer will recommend to the Chief Credit Officer whether a specific allowance or a charge-off should be taken. The Chief Credit Officer has the authority to approve a specific allowance or charge-off between monthly credit committee meetings to insure that there are no significant time lapses during this process.

The Company's methodology for evaluating whether a loan is impaired begins with risk-rating credits on an individual basis and includes consideration of the borrower's overall financial condition, payment record and available cash resources that may include the sufficiency of collateral value and, in a select few cases, verifiable support from financial guarantors. In measuring impairment, the Company looks primarily to the discounted cash flows of the project itself or to the value of the collateral as the primary sources of repayment of the loan. The Company may consider the existence of guarantees and the financial strength and wherewithal of the guarantors involved in any loan relationship. Guarantees may be considered as a source of repayment based on the guarantor's financial condition and respective payment capacity. Accordingly, absent a verifiable payment capacity, a guarantee alone would not be sufficient to avoid classifying the loan as impaired.

Management has established a credit process that dictates that structured procedures be performed to monitor these loans between the receipt of an original appraisal and the updated appraisal. These procedures include the following:

- An internal evaluation is updated quarterly to include borrower financial statements and/or cash flow projections.

- The borrower may be contacted for a meeting to discuss an updated or revised action plan which may include a request for additional collateral.

- Re-verification of the documentation supporting the Company's position with respect to the collateral securing the loan.

- At the monthly credit committee meeting the loan may be downgraded and a specific allowance may be decided upon in advance of the receipt of the appraisal.

- Upon receipt of the updated appraisal (or based on an updated internal financial evaluation) the loan balance is compared to the appraisal and a specific allowance is decided upon for the particular loan, typically for the amount of the difference between the appraisal and the loan balance.

- The Company will specifically reserve for or charge-off the excess of the loan amount over the amount of the appraisal. In certain cases the Company may establish a larger reserve due to knowledge of current market conditions or the existence of an offer for the collateral that will facilitate a more timely resolution of the loan.

If an updated appraisal is received subsequent to the preliminary determination of a specific allowance or partial charge-off, and it is less than the initial appraisal used in the initial charge-off, an additional specific allowance or charge-off is taken on the related credit. Partially charged-off loans are not written back up based on updated appraisals and always remain on non-accrual with any and all subsequent payments applied to the remaining balance of the loan as principal reductions. No interest income is recognized on loans that have been partially charged-off.

Loans that have their terms restructured (e.g., interest rates, loan maturity date, payment and amortization period, etc.) in circumstances that provide payment relief or other concessions, to a borrower experiencing financial difficulty are considered troubled debt restructured loans (TDR's). All restructurings that constitute concessions to a troubled borrower are considered impaired loans and may either be in accruing status or non-accruing status. Non-accruing restructured loans may return to accruing status provided there is a sufficient period of payment performance in accordance with the restructure terms. Loans may be removed from the restructured category in the year subsequent to the restructuring if their revised loans terms are considered to be consistent with terms that can be obtained in the credit market for loans with comparable risk.

The Company may extend the maturity of a performing or current loan that may have some inherent weakness associated with the loan. However, the Company generally follows a policy of not extending maturities on non-performing loans under existing terms. Maturity date extensions only occur under revised terms that clearly place the Company in a position to increase the likelihood of or assure full collection of the loan under the contractual terms and /or terms at the time of the extension that may eliminate or mitigate the inherent weakness in the loan. These terms may incorporate, but are not limited to additional assignment of collateral, significant balance curtailments/liquidations and assignments of additional project cash flows. Guarantees may be a consideration in the extension of loan maturities. As a general matter, the Company does not view extension of a loan to be a satisfactory approach to resolving non-performing credits. On an exception basis, certain performing loans that have displayed some inherent weakness in the underlying collateral values, an inability to comply with certain loan covenants which are not affecting the performance of the credit or other identified weakness may be extended.

Collateral values or estimates of discounted cash flows (inclusive of any potential cash flow from guarantees) are evaluated to estimate the probability and severity of potential losses. Impairment is established based on the Company's calculation of the probable loss inherent in the individual loan. The actual occurrence and severity of losses involving impaired credits can differ substantially from estimates.

Management believes that the allowance is adequate. However, its determination requires significant judgment, and estimates of probable losses in the loan and lease portfolio can vary significantly from the amounts actually observed. While management uses available information to recognize probable losses, future additions to the allowance may be necessary based on changes in the credits comprising the portfolio and changes in the financial condition of borrowers, such as may result from changes in economic conditions. In addition, federal and state regulatory agencies, as an integral part of their examination process, and independent consultants engaged by the Bank, periodically review the loan and lease portfolio and the allowance. Such reviews may result in adjustments to the allowance based upon their analysis of the information available at the time of each examination.

The Company makes provisions for loan and lease losses in amounts necessary to maintain the allowance at an appropriate level, as established by use of the allowance methodology discussed above. The provision decreased in the second quarter of 2012 compared to the prior year period. The provision for loan and lease losses also declined for the full year 2011 compared to 2010 and that trend has continued. These declines have been the result of the decline in historical charge-offs which is a principal component in the application of the Company's allowance methodology.

Substantially all of the fixed-rate conforming residential mortgage loans originated by the Company are sold in the secondary mortgage market. Concurrent with such sales, the Company is required to make customary representations and warranties to the purchasers about the mortgage loans and the manner in which they were originated. The related sale agreements grant the purchasers recourse back to the Company, which could require the Company to repurchase loans or to share in any losses incurred by the purchasers. This recourse exposure typically extends for a period of six to eighteen months after the sale of the loan. Such transactions could be due to a number of causes including borrower fraud or early payment default. The Company has seen a very limited number of repurchase and indemnity demands from purchasers for such events and routinely monitors its exposure in this regard. The Company maintains a liability of \$0.5 million for possible losses due to repurchases. Given its lack of history as to losses of this type, the Company believes that this reserve is adequate.

#### Allowance for Loan and Lease Losses

During 2012, there were no changes in the Company's systematic methodology for assessing the appropriateness of the allowance for loan and lease losses from the prior year. Variations can occur over time in the methodology's estimation of the adequacy of the allowance as a result of the credit performance of borrowers. There was no unallocated allowance at June 30, 2012 or December 31, 2011, when measured against the total allowance.

At June 30, 2012, total non-performing loans and leases were \$64.5 million, or 2.60% of total loans and leases, compared to \$79.1 million, or 3.53% of total loans and leases, at December 31, 2011. Timely recognition and aggressive management of problem credits has resulted in the significant reduction of the migration of these loans into non-accrual status during this period. The lower amount of problem credits relative to the total credit portfolio combined with the reduction in the allowance results in a decline in the ratio of the allowance to problem credits. The allowance represented 70% of non-performing loans and leases at June 30, 2012 and 62% at December 31, 2011. Continued analysis of the actual loss history on the problem credits in 2011 and 2012 provided an indication that the

coverage of the inherent losses on the problem credits was adequate. The Company continues to monitor the impact of the economic conditions on our commercial customers, the reduced inflow of non-accruals, lower inflow in criticized loans and the significant decline in early stage delinquencies. The improvement in these credit metrics support management's outlook for continued improved credit quality performance.

The balance of impaired loans was \$57.6 million, with specific allowances of \$4.9 million against those loans at June 30, 2012, as compared to \$67.6 million with allowances of \$7.8 million, at December 31, 2011.

The Company's borrowers are concentrated in six counties in Maryland, three counties in Virginia and in Washington D.C. Commercial and residential mortgages, including home equity loans and lines, represented 74% of total loans and leases at both June 30, 2012 compared to 75% at December 31, 2011. Certain loan terms may create concentrations of credit risk and increase the Company's exposure to loss. These include terms that permit the deferral of principal payments or payments that are smaller than normal interest accruals (negative amortization); loans with high loan-to-value ratios; loans, such as option adjustable-rate mortgages, that may expose the borrower to future increases in repayments that are in excess of increases that would result solely from increases in market interest rates; and interest-only loans. The Company does not make loans that provide for negative amortization or option adjustable-rate mortgages.

**Summary of Loan and Lease Loss Experience**

The following table presents the activity in the allowance for loan and lease losses for the periods indicated:

| (Dollars in thousands)                                 | Six Months Ended<br>June 30, 2012 | Year Ended<br>December 31, 2011 |      |   |
|--|-----------------------------------|---------------------------------|------|---|
| Analysis of Allowance for Loan Losses:                 |                                   |                                 |      |   |
| Balance, January 1                                     | \$ 49,426                         | \$ 62,135                       |      |   |
| Provision (credit) for loan and lease losses           | 2,249                             | 1,428                           |      |   |
| Charge-offs:   |                                   |                                 |      |   |
| Commercial business                                    | (354                              | (2,565                          | )    | ) |
| Commercial real estate:                                |                                   |                                 |      |   |
| Commercial acquisition, development and construction   | (1,076                            | (1,780                          | )    | ) |
| Commercial investor real estate                        | (3,457                            | (868                            | )    | ) |
| Commercial owner occupied real estate                  | (493                              | (487                            | )    | ) |
| Leasing  | (6                                | (1,072                          | )    | ) |
| Consumer   | (697                              | (2,740                          | )    | ) |
| Residential real estate:                               |                                   |                                 |      |   |
| Residential mortgage                                   | (1,193                            | (5,178                          | )    | ) |
| Residential construction                               | (67                               | (1,815                          | )    | ) |
| Total charge-offs                                      | (7,343                            | (16,505                         | )    | ) |
| Recoveries:  |                                   |                                 |      |   |
| Commercial business                                    | 578                               | 674                             |      |   |
| Commercial real estate:                                |                                   |                                 |      |   |
| Commercial acquisition, development and construction   | 59                                | 1,238                           |      |   |
| Commercial investor real estate                        | 98                                | 3                               |      |   |
| Commercial owner occupied real estate                  | 9                                 | -                               |      |   |
| Leasing  | 4                                 | 18                              |      |   |
| Consumer   | 121                               | 209                             |      |   |
| Residential real estate:                               |                                   |                                 |      |   |
| Residential mortgage                                   | 60                                | 221                             |      |   |
| Residential construction                               | 4                                 | 5                               |      |   |
| Total recoveries                                       | 933                               | 2,368                           |      |   |
| Net charge-offs  | (6,410                            | (14,137                         | )    | ) |
| Balance at end of period                               | \$ 45,265                         | \$ 49,426                       |      |   |
| Allowance for loan losses to loans                     | 1.83                              | %                               | 2.21 | % |
| Annualized net charge-offs to average loans and leases | 0.56                              | %                               | 0.66 | % |

**Analysis of Credit Risk**

The following table presents information with respect to non-performing assets and 90-day delinquencies for the periods indicated:

| (Dollars in thousands)                            | June 30, 2012 | December 31, 2011 |       |   |
|---|---------------|-------------------|-------|---|
| <b>Non-Performing Assets:</b>                     |               |                   |       |   |
| <b>Loans and leases 90 days past due:</b>         |               |                   |       |   |
| Commercial business                               | \$ 70         | \$ -              |       |   |
| <b>Commercial real estate:</b>                    |               |                   |       |   |
| Commercial AD&C                                   | 342           | -                 |       |   |
| Commercial investor real estate                   | -             | -                 |       |   |
| Commercial owner occupied real estate             | -             | -                 |       |   |
| Leasing   | 96            | 2                 |       |   |
| Consumer  | 5             | 165               |       |   |
| <b>Residential real estate:</b>                   |               |                   |       |   |
| Residential mortgage                              | 91            | 167               |       |   |
| Residential construction                          | -             | 243               |       |   |
| Total loans and leases 90 days past due           | 604           | 577               |       |   |
| <b>Non-accrual loans and leases:</b>              |               |                   |       |   |
| Commercial business                               | 4,583         | 7,226             |       |   |
| <b>Commercial real estate:</b>                    |               |                   |       |   |
| Commercial AD&C                                   | 13,055        | 18,702            |       |   |
| Commercial investor real estate                   | 13,327        | 16,963            |       |   |
| Commercial owner occupied real estate             | 15,146        | 14,709            |       |   |
| Leasing   | 872           | 853               |       |   |
| Consumer  | 1,651         | 1,786             |       |   |
| <b>Residential real estate:</b>                   |               |                   |       |   |
| Residential mortgage                              | 2,600         | 5,722             |       |   |
| Residential construction                          | 4,333         | 5,719             |       |   |
| Total non-accrual loans and lease                 | 55,567        | 71,680            |       |   |
| Total restructured loans - accruing               | 8,285         | 6,881             |       |   |
| Total non-performing loans and leases             | 64,456        | 79,138            |       |   |
| Other assets and real estate owned (OREO)         | 9,553         | 4,431             |       |   |
| Total non-performing assets                       | \$ 74,009     | \$ 83,569         |       |   |
| Non-performing loans to total loans               | 2.60          | %                 | 3.53  | % |
| Non-performing assets to total assets             | 1.92          | %                 | 2.25  | % |
| Allowance for loan losses to non-performing loans | 70.23         | %                 | 62.46 | % |

The most significant fair value adjustment in the purchase accounting for the CommerceFirst acquisition was to loans. As of May 31, 2012, certain of the loans acquired from Commerce First had evidence of credit deterioration since origination, and it was probable that the Company would not collect all contractually required principal and interest payments. Such loans identified at the time of acquisition are accounted for under GAAP which requires that acquired

credit-impaired loans be recorded at fair value and prohibits carryover of the related allowance for loan and lease losses.



Loans with credit deterioration since origination were written down to an amount estimated to be collectible as the Company expects to fully collect the new carrying values of such loans (that is, the new cost basis arising out of the Company's purchase accounting).

As a result of the acquisition of CommerceFirst's loan portfolio, certain credit-related ratios of the Company, including, for example, the growth rate in non-performing assets since December 31, 2011, may not necessarily be directly comparable with periods prior to the merger or with credit-related ratios of other financial institutions.

### **Market Risk Management**

The Company's net income is largely dependent on its net interest income. Net interest income is susceptible to interest rate risk to the extent that interest-bearing liabilities mature or re-price on a different basis than interest-earning assets. When interest-bearing liabilities mature or re-price more quickly than interest-earning assets in a given period, a significant increase in market rates of interest could adversely affect net interest income. Similarly, when interest-earning assets mature or re-price more quickly than interest-bearing liabilities, falling interest rates could result in a decrease in net interest income. Net interest income is also affected by changes in the portion of interest-earning assets that are funded by interest-bearing liabilities rather than by other sources of funds, such as noninterest-bearing deposits and stockholders' equity.

The Company's interest rate risk management goals are (1) to increase net interest income at a growth rate consistent with the growth rate of total assets, and (2) to minimize fluctuations in net interest margin as a percentage of interest-earning assets. Management attempts to achieve these goals by balancing, within policy limits, the volume of floating-rate liabilities with a similar volume of floating-rate assets; by keeping the average maturity of fixed-rate asset and liability contracts reasonably matched; by maintaining a pool of administered core deposits; and by adjusting pricing rates to market conditions on a continuing basis.

The Company's board of directors has established a comprehensive interest rate risk management policy, which is administered by management's ALCO. The policy establishes limits on risk, which are quantitative measures of the percentage change in net interest income (a measure of net interest income at risk) and the fair value of equity capital (a measure of economic value of equity or "EVE" at risk) resulting from a hypothetical change in U.S. Treasury interest rates for maturities from one day to thirty years. The Company measures the potential adverse impacts that changing interest rates may have on its short-term earnings, long-term value, and liquidity by employing simulation analysis through the use of computer modeling. The simulation model captures optionality factors such as call features and interest rate caps and floors imbedded in investment and loan portfolio contracts. As with any method of gauging interest rate risk, there are certain shortcomings inherent in the interest rate modeling methodology used by the Company. When interest rates change, actual movements in different categories of interest-earning assets and interest-bearing liabilities, loan prepayments, and withdrawals of time and other deposits, may deviate significantly from assumptions used in the model. Finally, the methodology does not measure or reflect the impact that higher rates may have on adjustable-rate loan customers' ability to service their debts, or the impact of rate changes on demand for loan, lease, and deposit products.

The Company prepares a current base case and eight alternative simulations at least once a quarter and reports the analysis to the board of directors. In addition, more frequent forecasts are produced when interest rates are particularly uncertain or when other business conditions so dictate.

The statement of condition is subject to quarterly testing for eight alternative interest rate shock possibilities to indicate the inherent interest rate risk. Average interest rates are shocked by +/- 100, 200, 300, and 400 basis points ("bp"), although the Company may elect not to use particular scenarios that it determines are impractical in a current rate environment. It is management's goal to structure the balance sheet so that net interest earnings at risk over a twelve-month period and the economic value of equity at risk do not exceed policy guidelines at the various interest rate shock levels.

The Company augments its quarterly interest rate shock analysis with alternative external interest rate scenarios on a monthly basis. These alternative interest rate scenarios may include non-parallel rate ramps and non-parallel yield curve twists. If a measure of risk produced by the alternative simulations of the entire balance sheet violates policy guidelines, ALCO is required to develop a plan to restore the measure of risk to a level that complies with policy limits within two quarters.

Measures of net interest income at risk produced by simulation analysis are indicators of an institution's short-term performance in alternative rate environments. These measures are typically based upon a relatively brief period, usually one year. They do not necessarily indicate the long-term prospects or economic value of the institution.

## Estimated Changes in Net Interest Income

| Change in Interest Rates: | + 400 bp | + 300 bp | + 200 bp | + 100bp | - 100 bp | - 200 bp | -300 bp | -400 bp |
|---------------------------|----------|----------|----------|---------|----------|----------|---------|---------|
| Policy Limit              | 23.50 %  | 17.50 %  | 15.00 %  | 10.00 % | 10.00 %  | 15.00 %  | 17.50 % | 23.50 % |
| June 30, 2012             | 0.04 %   | 1.45 %   | 1.93 %   | 0.97 %  | N/A      | N/A      | N/A     | N/A     |
| December 31, 2011         | (4.09 )% | (1.66 )% | (0.06 )% | 0.11 %  | N/A      | N/A      | N/A     | N/A     |

As shown above, measures of net interest income at risk improved from December 31, 2011 at all rising interest rate shock levels. All measures remained well within prescribed policy limits.

The primary contributor to the improved risk position with respect to net interest income was the longer duration in borrowings caused by the payoff of \$80 million in overnight borrowings early in the second quarter of 2012. Loans acquired in the CommerceFirst acquisition resulted in an increase in the loan portfolio which has a shorter duration as compared to the longer duration of the investment portfolio. This more than offset the longer duration in the loan and investment portfolios at December 31, 2011.

The measures of equity value at risk indicate the ongoing economic value of the Company by considering the effects of changes in interest rates on all of the Company's cash flows, and by discounting the cash flows to estimate the present value of assets and liabilities. The difference between these discounted values of the assets and liabilities is the economic value of equity, which, in theory, approximates the fair value of the Company's net assets.

## Estimated Changes in Economic Value of Equity (EVE)

| Change in Interest Rates: | + 400 bp | + 300 bp | + 200 bp | + 100bp | - 100 bp | - 200 bp | -300 bp | -400 bp |
|---------------------------|----------|----------|----------|---------|----------|----------|---------|---------|
| Policy Limit              | 35.00 %  | 25.00 %  | 20.00 %  | 10.00 % | 10.00 %  | 20.00 %  | 25.00 % | 35.00 % |
| June 30, 2012             | (5.90 )% | (2.10 )% | 0.58 %   | 1.36 %  | N/A      | N/A      | N/A     | N/A     |
| December 31, 2011         | (7.25 )% | (5.16 )% | (1.26 )% | 0.99 %  | N/A      | N/A      | N/A     | N/A     |

Measures of the economic value of equity ("EVE") at risk improved compared to year-end 2011 in all rising interest rate shock levels. The positive impact on EVE is caused by lower long-term market rates which create higher market values in the investment portfolio thus offsetting the longer durations on investments and loans. In addition, the market value of noninterest-bearing checking accounts also increased due to the deposits added from the CommerceFirst acquisition.

## Liquidity Management

Liquidity is measured by a financial institution's ability to raise funds through loan and lease repayments, maturing investments, deposit growth, borrowed funds, capital and the sale of highly marketable assets such as investment securities and residential mortgage loans. The Company's liquidity position, considering both internal and external sources available, exceeded anticipated short-term and long-term needs at June 30, 2012. Management considers core

deposits, defined to include all deposits other than time deposits of \$100 thousand or more, to be a relatively stable funding source. Core deposits equaled 73% of total interest-earning assets at June 30, 2012. In addition, loan and lease payments, maturities, calls and pay downs of securities, deposit growth and earnings contribute a flow of funds available to meet liquidity requirements. In assessing liquidity, management considers operating requirements, the seasonality of deposit flows, investment, loan and deposit maturities and calls, expected funding of loans and deposit withdrawals, and the market values of available-for-sale investments, so that sufficient funds are available on short notice to meet obligations as they arise and to ensure that the Company is able to pursue new business opportunities.

Liquidity is measured using an approach designed to take into account, in addition to factors already discussed above, the Company's growth and mortgage banking activities. Also considered are changes in the liquidity of the investment portfolio due to fluctuations in interest rates. Under this approach, implemented by the Funds Management Subcommittee of ALCO under formal policy guidelines, the Company's liquidity position is measured weekly, looking forward at thirty day intervals from thirty (30) to three hundred sixty (360) days. The measurement is based upon the projection of funds sold or purchased position, along with ratios and trends developed to measure dependence on purchased funds and core growth. Resulting projections as of June 30, 2012, show short-term investments exceeding short-term borrowings by \$30.7 million over the subsequent 360 days. This projected excess of liquidity versus requirements provides the Company with flexibility in how it funds loans and other earning assets.

The Company also has external sources of funds, which can be drawn upon when required. The main sources of external liquidity are available lines of credit with the Federal Home Loan Bank of Atlanta and the Federal Reserve. The line of credit with the Federal Home Loan Bank of Atlanta totaled \$1.1 billion, of which \$602.5 million was available for borrowing based on pledged collateral, with \$405.2 million borrowed against it as of June 30, 2012. The line of credit at the Federal Reserve totaled \$373.9 million, all of which was available for borrowing based on pledged collateral, with no borrowings against it as of June 30, 2012. Other external sources of liquidity available to the Company in the form of unsecured lines of credit granted by correspondent banks totaled \$55.0 million at June 30, 2012, against which there were no outstanding borrowings. In addition, the Company had a secured line of credit with a correspondent bank of \$20.0 million as of June 30, 2012. Based upon its liquidity analysis, including external sources of liquidity available, management believes the liquidity position was appropriate at June 30, 2012.

The parent company (“Bancorp”) is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, Bancorp is responsible for paying any dividends declared to its common shareholders and interest and principal on outstanding debt. Bancorp’s primary source of income is dividends received from the Bank. The amount of dividends that the Bank may declare and pay to Bancorp in any calendar year, without the receipt of prior approval from the Federal Reserve, cannot exceed net income for that year to date plus retained net income (as defined) for the preceding two calendar years. Based on this requirement, as of June 30, 2012, the Bank could have declared a dividend of \$47.9 million to Bancorp. At June 30, 2012, Bancorp had liquid assets of \$9.4 million.

Arrangements to fund credit products or guarantee financing take the form of loans commitments (including lines of credit on revolving credit structures) and letters of credit. Approvals for these arrangements are obtained in the same manner as loans. Generally, cash flows, collateral value and risk assessment are considered when determining the amount and structure of credit arrangements. Commitments to extend credit in the form of consumer, commercial real estate and business at the dates indicated were as follows:

| (In thousands)  | June 30,<br>2012 | December 31,<br>2011 |
|---|------------------|----------------------|
| Commercial  | \$151,373        | \$ 79,567            |
| Real estate-development and construction                      | 61,961           | 76,940               |
| Real estate-residential mortgage                              | 44,308           | 20,922               |
| Lines of credit, principally home equity and business lines   | 662,285          | 621,422              |
| Standby letters of credit                                     | 55,164           | 73,913               |
| Total Commitments to extend credit and available credit lines | \$975,091        | \$ 872,764           |

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

See “Financial Condition - Market Risk and Interest Rate Sensitivity” in Management’s Discussion and Analysis of Financial Condition and Results of Operations, above, which is incorporated herein by reference.

**Item 4. CONTROLS AND PROCEDURES**

The Company’s management, under the supervision and with the participation of the Company’s Chief Executive Officer and Chief Financial Officer, evaluated as of the last day of the period covered by this report, the effectiveness of the design and operation of the Company’s disclosure controls and procedures, as defined in Rule 13a-15 under the Securities Exchange Act of 1934. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures were effective. There were no changes in the Company’s internal controls over financial reporting (as defined in Rule 13a-15 under the Securities Act of 1934) during the three months ended June 30, 2012, that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings**

In the normal course of business, the Company becomes involved in litigation arising from the banking, financial and other activities it conducts. Management, after consultation with legal counsel, does not anticipate that the ultimate liability, if any, arising from these matters will have a material effect on the Company’s financial condition, operating results or liquidity.

**Item 1A. Risk Factors**

There have been no material changes in the risk factors as discussed in the 2011 Annual Report on Form 10-K.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The Company approved a stock repurchase program in August 2011 that permits the repurchase of up to 3% of the Company's outstanding shares of common stock or approximately 730,000 shares. Repurchases which will be conducted through open market purchases or privately negotiated transactions, will be made depending on market conditions and other factors. For the year ended December 31, 2011, the Company repurchased 23,592 shares of common stock. There were no repurchase transactions executed during the quarter ended June 30, 2012.

**Item 3. Defaults Upon Senior Securities – None**

**Item 4. Mine Safety Disclosures – Not applicable**

**Item 5. Other Information - None**

**Item 6. Exhibits**

Exhibit  
31(a) Certification of Chief Executive Officer

Exhibit  
31(b) Certification of Chief Financial Officer

Exhibit  
32 (a) Certification of Chief Executive Officer pursuant to 18 U.S. Section 1350

Exhibit  
32 (b) Certification of Chief Financial Officer pursuant to 18 U.S. Section 1350

Exhibit  
101 The following materials from the Sandy Spring Bancorp, Inc. Quarterly Report on Form 10-Q for the quarter end March 31, 2012 formatted in Extensible Business Reporting Language (XBRL): (i) the Condensed Consolidated Statements of Condition; (ii) The Condensed Consolidated Statements of Income; (iii) The Condensed Consolidated Statements of Cash Flows; (iv) The Condensed Consolidated Statements of Changes in Stockholders' Equity; (v) related notes.

Signatures

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Registrant has duly caused this quarterly report to be signed on its behalf by the undersigned, thereunto duly authorized.

SANDY SPRING BANCORP, INC.

(Registrant)

By: /s/ Daniel J. Schrider  
Daniel J. Schrider  
President and Chief  
Executive Officer

Date: August 9, 2012

By: /s/ Philip J. Mantua  
Philip J. Mantua  
Executive Vice  
President and Chief  
Financial Officer

Date: August 9, 2012